The Strategic Review of Charges 2006-10: The draft determination

Introduction and background

volume 2

WATER INDUSTRY COMMISSIONER FOR SCOTLAND

Contents

Executive summary

Introduction

The current Strategic Review of Charges will set price limits for the 2006-10 regulatory control period. This will be the first time that this Office will determine rather than advise Ministers on the appropriate level of charges. We have now collected and analysed a significant amount of information both from Scottish Water and other sources. In this draft determination we present the preliminary conclusions of the Strategic Review of Charges. There will now be a period until 23 September 2005 during which stakeholders can comment on the charge caps we have suggested are appropriate. The final charge determination will be published at the end of November 2005 by the new Water Industry Commission. The maximum charges under this determination will take effect from April 2006.

Scottish Water remains in the public sector, and is accountable to the Scottish Parliament through the Scottish Ministers. In May 2004, Ross Finnie, the Minister for Environment and Rural Affairs, wrote to both the Chairman of Scottish Water and to this Office in order to commission work on the Strategic Review of Charges 2006-10.

This was followed in February 2005 with Ministerial Guidance on:

- what Scottish Water was to achieve during the review period 2006-10;
- the principles that this Office 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.

Role of the Water Industry Commissioner for Scotland

Part II of the Water Industry Act 1999 created the post of the Water Industry Commissioner for Scotland and this Office was established on 1 November 1999. The Commissioner's primary role is to promote the interests of customers of Scottish Water. One of the most important duties is to advise the Scottish Ministers on the amount of revenue that Scottish Water needs to fund its investment programme and meet the required levels of service.

Since this Office was created in 1999, the scope of our activities has broadened. In our first two years of operation we concentrated on the first full Strategic Review of Charges (which covered the period 2002-06) and on collecting the information that was essential to that review. Gradually our ongoing monitoring of Scottish Water's performance has taken on greater significance. This monitoring role ensures that customers receive improved value for money and can be confident that the benefits of increased investment are realised.

The Water Services etc. (Scotland) Act 2005 further develops the role of this Office. The Act establishes a Commission in place of a single Commissioner. It also sets up a framework for retail competition for non-household customers. This Office will assume the role of licensing authority. These changes are further discussed below.

The Strategic Review of Charges 2002-06

In the Strategic Review of Charges 2002-06, we advised that if the industry met the challenges it faced, then by 2006 customers could expect that their bills would not have to increase in real terms in order for them to enjoy an environmentally and financially sustainable service. Scottish Water has made a solid start in meeting the challenges that were set in the 2002-06 Strategic Review. It is this significant improvement in performance that underpins the relatively positive price outlook contained in this draft determination of charges.

Principal aims of the Strategic Review of Charges 2006-10

Customers will rightly expect us to have built on progress since the last Strategic Review of Charges. We have set charges that are sufficient, but no more than sufficient, to deliver the required level of service to customers.

The principal aims of this Strategic Review are to ensure that:

- charges are set at the lowest reasonable level that is consistent with the delivery of the Ministers' objectives for the industry; and

- Scottish Water further narrows the gap between its performance and that of the companies south of the border.

The role of regulation

Monopolies can exist in both the public and private sectors. An effective monopoly is present when most, if not all, customers do not have any real choice and when the dominant market supplier determines the terms and price of supply.

While a few companies may have some choice in their arrangements for a water and sewerage service, Scottish Water is an effective monopoly. Similarly, in England and Wales, although an industrial or commercial customer in one area can request a service from a supplier in an adjoining area, in most cases this is not economically viable.

The purpose of regulation is to seek to ensure that such monopoly businesses act in the customer interest. Regulators can act to encourage the supplier to provide a better level of service to customers (customer service regulation) or to reduce costs while maintaining the level of service (economic regulation).

Types of regulatory frameworks

There are three main regulatory models:

- **Cost-of-service (rate of return) regulation:** in this model the regulator sets the return that can be earned on investment by companies. This enables a company to recoup, at a set rate, the costs and investments that it has put in to provide the services provided these are in line with the agreed budget. Cost-of-service regulation includes no incentive to minimise costs or to avoid 'gold-plating' of assets.

- **Price cap regulation:** price cap regulation (RPI-X) sets the maximum prices that companies can charge for their services for a period of years. This provides an incentive to a company to improve its efficiency. This is because it has to drive down costs in order to improve returns to the shareholder or, in the case of Glas Cymru[1], deliver the rebates to customers' bills that were promised by management.

- **Franchise regulation:** under franchise regulation, the regulator invites companies to bid for the right to provide services to the public. The company that offers the best price-quality package wins the bid and will contract to provide the services at a certain price and to a defined quality standard.

How economic regulation differs in the public sector

All UK economic regulators adopt an incentive-based approach to determining charges. The analysis is complex and thorough, but essentially the regulator analyses the scope for improvement in performance.

A determined management may out-perform the targets and in doing so will benefit the shareholders (private companies) or customers (Glas Cymru), but such out-performance will also raise the level of performance expected at future reviews. It is this 'ratchet' approach that has resulted in the significant efficiency gains south of the border.

Regulators normally rely on shareholders to exert pressure on management to out-perform efficiency targets. More recently, however, the creation of not-for-dividend companies (such as Glas Cymru and Network Rail) and the introduction of regulation to public sector companies (such as Scottish Water and Royal Mail) has led regulators to refine their approach.

Regulators have, in general, concluded that incentive-based regulation can be used to regulate the not-for-dividend or public sector companies. Obviously they cannot rely on shareholder pressure to improve value for money to customers. This has required the regulators to focus on corporate governance and incentive frameworks.

In regulating the water industry in Scotland, we want to ensure that we take full advantage of the relatively cheap

[1] Glas Cymru is a not-for-profit company limited by guarantee which acquired Welsh Water in May 2001.

government borrowing that is available. At the same time, we are mindful not to reduce the impact of the tight budgetary constraint on current management or to increase bills for future customers disproportionately.

In the private sector, there exists a contractual relationship between the Government and the private utilities. Each utility has a licence to operate that requires it to meet standards of operation that are considered appropriate in terms of social, environmental, and public health policy objectives. The economic regulator takes account of all such issues that arise from legislation or other government guidance when determining the outputs that are to be delivered, and then sets the charge limits accordingly. Thereafter, he depends on shareholder pressure to ensure that these are delivered as efficiently as management can achieve, and simply has to monitor performance to ensure that the defined standards are properly achieved.

In the public sector, the regulator has to assess the lowest reasonable overall cost of delivering the objectives set by the Scottish Ministers. He cannot rely on the presence of market forces to deliver efficiency.

Regulation of Scottish Water as a public sector organisation

We use comparative analysis to promote continued improvements in customer service standards, environmental and public health compliance and financial performance. Experience from other utilities and from the water industry south of the border has shown that this can bring significant benefits to customers and the environment through lower costs, improved environmental and water quality standards and better customer service. Our approach is similar to that employed by other regulators, including the Office of Water Services (Ofwat), which regulates the water and sewerage companies in England and Wales.

If a public sector organisation can match the level of efficiency of investment and service delivery that is achieved by the private sector, customers of that public sector supplier could expect sustainably lower charges than could ever be achieved by the private sector. This is because the public sector is consistently able to access a lower cost of capital.

Although direct comparisons can be difficult, a comparison with Ofwat's allowed cost of capital is instructive.

Ofwat's allowed cost of capital for the period 2005-10 is 5.10% **real post-tax** for the water and sewerage companies. In contrast, the weighted average interest rate for new loans taken out by Scottish Water since its creation was 4.16% nominal pre-tax (equivalent to 0.41% real post-tax). We have allowed Scottish Water a slightly higher cost of capital (comprising a 4.6% nominal pre-tax return on debt and a 3.22% nominal pre-tax cost of customer retained earnings). We estimate that Scottish Water's customers probably benefit by more than £100-£140 million a year as a result of this saving on the annual cost of capital. This saving is likely to increase over time if Scottish Water continues to enjoy access to public borrowing.

It is, however, important to note that this cost benefit will only truly be realised by customers if they are not exposed to operational risks and if the service is delivered efficiently. We have proposed that a mechanism is put in place that compensates customers for the risks that they have borne.

We have limited the risk to customers of Scottish Water by adopting a prudent approach to the financing of Scottish Water's activities. This is in line with the Ministerial Guidance on the principles of charging. The final determination should be seen as an agreement between customers and Scottish Water about the level of service that will be provided during the period.

We believe that incentive-based regulation will benefit customers by ensuring that the business has an incentive to improve its efficiency further and more quickly than if we simply set targets, the achievement of which becomes the only objective.

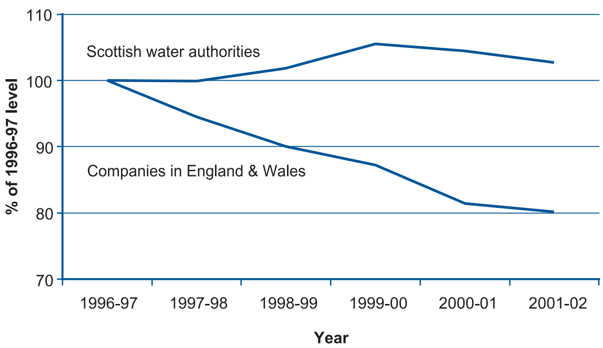
For incentive-based regulation to work, it is essential that managerial incentives are available only for out-performance of targets, not for progress towards them.

It is at least equally important that, in future, customers are not asked to pay twice for the agreed level of service. We are pleased that the Minister has recognised the importance of a tight budgetary constraint in the Ministerial Guidance[2].

How economic regulation of the Scottish water industry has already benefited customers

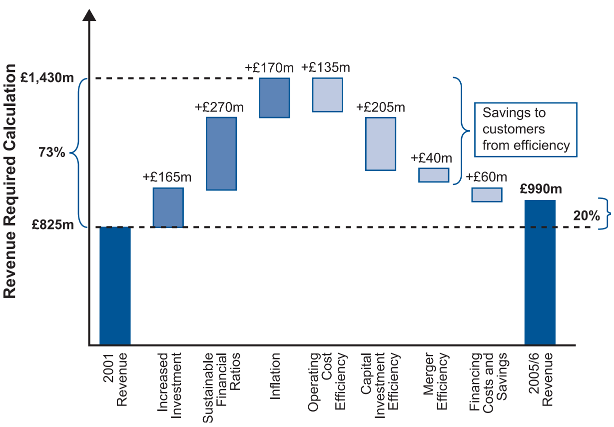
In their last years of operation the three former water authorities were becoming less efficient at a time when the industry in England and Wales continued to improve its performance. This is illustrated in Figure 1.

Figure 1: Trends in base operating costs of predecessor authorities 1996-97 to 2001-02



The scope for efficiency that we identified reduced the required increase in average prices from some 73% to a still significant, but more acceptable, 20%.

Figure 2: The scope for efficiency and other savings



2 Paragraphs 20 and 21 of the Ministerial Guidance of February 2005.

The actual level of operating costs inherited by Scottish Water was some £20 million higher than expected when we completed the Strategic Review of Charges 2002-06. We now expect that Scottish Water will have cut costs by some £145 million in real terms during the regulatory control period 2002-06. Scottish Water has done well over the last four years and these savings will continue to benefit customers in the period 2006-10. Total real operating cost savings will be greater than projected in our advice to Ministers.

The regulatory framework

The regulatory framework for the water industry in Scotland is broadly similar to that in England and Wales. There are separate organisations which are responsible for customer service and economic regulation; environmental protection; and safeguarding public health.

We described the role of the Water Industry Commissioner for Scotland above. The other principal agencies that are responsible for representing stakeholders' views and regulating Scottish Water are described below.

The Water Customer Consultation Panels (WCCPs)

The Water Industry (Scotland) Act 2002 created five Water Customer Consultation Panels across Scotland to represent the views and interests of customers of Scottish Water in the areas covered by the Panels. The Panels are independent of Scottish Water and of other agencies, including the Water Industry Commissioner.

The Drinking Water Quality Regulator (DWQR)

The role of the Drinking Water Quality Regulator for Scotland was established by the Water Industry (Scotland) Act 2002. The DWQR provides an independent check that Scottish Water is complying with the drinking water quality regulations. These regulations reflect European Union and other statutory standards.

The Scottish Environment Protection Agency (SEPA)

The Scottish Environment Protection Agency is responsible for a range of activities, including the following.

- Regulating discharges to rivers, lochs, estuaries and coastal waters from industry, sewage treatment works, fish farms, septic tanks, etc.
- Protecting and improving the water environment, including River Basin Management Planning under the Water Environment and Water Services Act.

Changes in the regulatory framework

There have been a number of changes to the legislative framework since the last Strategic Review.

The Water Industry (Scotland) Act 2002

The Water Industry (Scotland) Act 2002, which had the principal function of establishing Scottish Water, also limited the function of this Office to promoting the interest of customers of Scottish Water's core business. As a result, the current Strategic Review of Charges focuses only on Scottish Water's core activities of providing water and sewerage services to customers in Scotland.

The Water Services etc. (Scotland) Act 2005

In 2005, the Water Services etc. (Scotland) Act further strengthened the regulatory framework.

The Act has two main functions.

- It creates a Water Industry Commission to replace the current Water Industry Commissioner. The Commission will have the power to determine (rather than to advise Ministers on) the maximum level of charges required to ensure that the objectives of the Scottish Ministers can be met at lowest reasonable cost.
- It introduces a framework for competition in the water industry that is consistent with the social, environmental and public health objectives of the Scottish Ministers.

Powers of determination

In England and Wales, Ofwat decides on the appropriate level of prices for the privatised companies south of the border after taking account of guidance that it receives from the Department for Environment, Food and Rural Affairs (DEFRA) and the Welsh Assembly Government. The Water Services etc. (Scotland) Act 2005 strengthens the regulatory framework for the water industry in Scotland, and brings the regulatory framework in Scotland more into line with England and Wales.

Broadly, a key function of regulators is to determine the charges levied by regulated companies. As a counterbalance to the powers of determination, Scottish Water, like other regulated companies, will have a right of challenge. There are two possible avenues for such challenges – the Competition Commission and judicial review.

If a regulated company disputes the regulator's price limits, it can require the regulator to refer the determination to the Competition Commission. The Competition Commission is an independent public body with the technical, economic and legal expertise to adjudicate in disputes between companies and their regulators.

In the UK, decisions of public bodies are generally subject to judicial review. In principle, the purpose of judicial review is to protect citizens from abuse by ensuring that the powers and duties of government and other public bodies are exercised properly and lawfully.

The Water Industry Commission for Scotland

The Commission will comprise a non-executive Chairman and four other non-executive members. The Chief Executive will also be a member of the

Commission. This will bring regulation of the water industry in Scotland more into line with the regulation of other utilities in the UK.

The Commission will have the power to determine caps for Scottish Water's charges for core services within a policy framework that is set by Ministers. It is important to recognise that Ministers retain responsibility for setting Scottish Water's objectives and for the principles that should apply in setting Scottish Water's charges. The Act clarifies roles and responsibilities.

Introducing a framework for competition

The Act includes provisions requiring the Water Industry Commission to introduce a regime to license retail competition for 'non-household' (business and commercial) customers. We propose that the licensing regime should be in place in Scotland by April 2008.

The key provisions relating to competition in the Act are as follows:

- Prohibitions on common carriage and on the provision of water and sewerage services to households by anyone other than Scottish Water.
- A duty on Scottish Water to establish a separate retail business in accordance with the requirements of Ministers.

The approach taken in the Act differs from that which has been introduced south of the border. In England and Wales, the Government decided to allow 'common carriage' but to phase the introduction of competition through the use of thresholds. The Government in England and Wales believes that common carriage raises practical issues for the incumbent water provider relating to how to manage the impact of new entrants gaining access to its infrastructure.

Establishing a licensing regime

The Act introduces two types of licence: one for the retail of water services and one for the retail of waste water services.

The Act places a duty on the Commission to monitor compliance with the terms and conditions of licences and to take any action necessary to ensure compliance. It is important that retailers pay a fair wholesale price that disadvantages neither businesses nor households. This will be achieved through the determination of wholesale charge caps.

Retail subsidiary of Scottish Water

The Act imposes a duty on Scottish Water to establish a retail subsidiary in accordance with the requirements of Scottish Ministers. This will clearly separate Scottish Water's statutory and licensed activities. The Scottish Water retail business will be in direct competition with other retailers. Scottish Water must not use or be thought to be using its position as sole provider of wholesale services to put competitors of its retail subsidiary at a disadvantage. The retail arm will be subject to the same regulation as other retailers, and must be treated by Scottish Water's wholesale business in the same way as other retailers.

One of the key challenges of this Strategic Review of Charges 2006-10 has been to set reasonable wholesale and retail charge caps. There has been no precedent in the water industry for the assessment of charge caps for the wholesale service. This review has set retail charge caps for household customers and retail and wholesale charge caps for the 'non-household' sector. In effect this has required us to decide the appropriate cost and profit of a retailer (ie the difference between retail prices and wholesale prices).

The overall level of wholesale charges is critical. If they are too high, new entrants will not be able to cover their costs and consequently will not enter the market. If they are too low, the core business of Scottish Water would suffer and retailers could make excessive profits.

We have sought to involve stakeholders so that all interested parties can understand how we set the wholesale charge. We did this by outlining a very detailed work plan for the Strategic Review of Charges 2006-10[3]. We also arranged a number of stakeholder information days, as well as four licensing information days.

[3] 'Our work in regulating the Scottish water industry: setting out a clear framework for the Strategic Review of Charges 2006-10', July 2004.

Additional powers to WCCPs

The Water Services etc. (Scotland) Act 2005 also transfers the responsibility for dealing with customer complaints from the Water Industry Commissioner for Scotland to the Convenor of the WCCPs. This responsibility sits better with the WCCPs, as the organisation responsible for representing the interests of customers.

Other inputs to the Strategic Review of Charges 2006-10

This section describes other major factors, in addition to the legislative changes outlined above, that have influenced this draft determination.

Better Regulation Task Force

The Better Regulation Task Force was established in 1997. It is an independent body, sponsored by the Cabinet Office, that advises the Government on action to ensure that regulation, and its enforcement, accord with the five Principles of Good Regulation. The Better Regulation Task Force has recommended that regulators should adopt five principles of good regulation in their approach to price setting: proportionality, accountability, consistency, transparency and targeting.

As part of our commitment to these principles, we have published all of the key information submissions that we have received from Scottish Water, as well as the tools that we have used to complete our analysis, including our financial and tariff basket models.

Ministerial Guidance

The Ministerial Guidance on the objectives for the water industry in Scotland was an important input to the Strategic Review of Charges. It provided information about the investment priorities that must be delivered and the principles of charging that should underpin the determination. The statement also set the borrowing limits that apply (or are likely to apply) during the four-year regulatory control period.

This draft determination has followed the terms of the original commissioning letter and subsequent Ministerial Guidance very closely.

Ministers may provide further guidance at the end of August 2005 in response to this draft determination of charges.

Regulatory returns and letters

Information is critical to effective regulation. We request information through a series of regular information returns and through regulatory letters. These regulatory requests can either be specific one-off requests or may initiate an additional regular request for information.

Scottish Water’s business plans

We set out the timetable for the Strategic Review of Charges in the summer of 2004. An important element of this timetable was the submission of two business plans by Scottish Water. We issued detailed guidance to Scottish Water on the scope to be covered and information to be included in these business plans. These business plans were submitted by Scottish Water in October 2004 and April 2005.

Implications of the changing framework

This draft determination has built on the solid foundation that we created in our 2002-06 Strategic Review. For this Review, we have been able to carry out more thorough analysis because we have access to better information.

The regulatory framework continues to evolve. We have introduced a Reporter and now publish both the Annual Return provided by Scottish Water and regular reports on Scottish Water’s performance.

In this draft determination we have endeavoured to make sure that the way we have benchmarked Scottish Water’s performance is easier to understand. This has involved three main changes:

- a move towards the regulatory capital value (RCV) method of price setting;
- adoption of the full range of cash-based financial ratios that Ofwat uses in regulating the companies in England and Wales; and
- the introduction of regulatory accounts.

The regulatory capital value approach to price setting

Ofwat uses the RCV approach in setting prices for the companies in England and Wales. We believe that we now have sufficient information about Scottish Water's assets and their remaining lives to move towards this method of price setting in future. It is important to understand that for the purposes of this Strategic Review of Charges, we are laying the ground for the future use of the RCV method of price setting at the next Review.

The introduction of the RCV method of setting prices will have no material impact on the prices faced by customers, the resources available to Scottish Water, or the implications for public expenditure. The changes are designed principally to allow greater transparency. Our move to the RCV method of price setting allows us to make a direct comparison of Scottish Water's financial sustainability with that of the companies south of the border.

Financial ratios

We have adopted the ratios that Ofwat used in its price determinations for 2005-10. Charges have been set in 2009-10 such that Scottish Water should have attained the same levels for the key cash-based ratios that Ofwat targeted in its Review. We have set an initial regulatory capital value consistent with this goal. Where Ofwat has stated that a target is 'around' a certain level, we have assumed that the ratio for Scottish Water should be within 25% of the target.

In their Ministerial Guidance, Ministers stressed the importance to customers of a smooth transition to the level of prices required in 2009-10. The charge caps we have set for each year of the Strategic Review of Charges 2006-10 are consistent with this objective.

Our analysis also suggested that this approach reduced the risk of substantial real price increases in the 2010-14 regulatory control period.

Introduction of regulatory accounts

The economic regulators establish and define the guidelines for regulatory accounts. Regulatory accounts do not necessarily follow the standard accounting guidelines (FRS, UKGAAP, etc) that are used for statutory financial accounts. Indeed, regulators have made it clear that in the event of a conflict between regulatory accounting guidelines and UKGAAP, the regulatory accounting guidelines would take precedence.

Each regulator sets out specific guidance for their sector. The specialist nature of regulatory accounts allows much tighter definitions of reporting requirements than is possible in standard accounting guidelines. Such tighter definition allows comparisons of performance both over time and between companies.

In England and Wales, regulatory accounts cover all aspects of the water and sewerage companies' finances. This comprehensive information allows Ofwat to compare financial performance fully and objectively, and to set appropriate targets for efficiency, capital investment and sustainable financial indicators. We have benefited from this comprehensive information in setting targets. The introduction of regulatory accounts for Scottish Water has allowed us to make more direct comparisons.

We have also used the regulatory accounts to ensure that we can distinguish clearly between the retail and wholesale costs. The regulatory accounting guidelines define the retail and wholesale activities in significant detail. There are also rules that determine the allocation of central overhead costs between the wholesale and retail business and the general trading relationship between the two legal entities and any other subsidiary companies of Scottish Water. We will ask the Reporter and Scottish Water's auditor to report on Scottish Water's compliance with these rules.

Critical issues

In the long run we believe that customers' interests are best served by a financially sustainable Scottish Water, operating within an effective and balanced governance and incentive framework. This will ensure that each generation of customers meets the costs of the level of service they have enjoyed.

In regulating Scottish Water, we are interested not only in the level of cost incurred but also in the level of service provided to customers. We have set levels of operating cost that reflect the improvements in the level of service we expect to see. Any shortfall in this level of service will reduce the revenue that will be made available to Scottish Water in the next regulatory control period.

Efficiency

We promote the interests of customers primarily by encouraging Scottish Water to deliver an appropriate level of service at the lowest reasonable overall cost. An efficient water and sewerage undertaker will carry out the minimum activity necessary to provide the service that is expected, at the lowest cost.

This definition applies equally to both operating costs and capital expenditure.

The charges paid by customers are a direct function of the efficiency of the water industry in Scotland.

Delivery of investment

It is critical that assets are maintained in an appropriate way and that problems are not stored up for the future.

In their February statement, Ministers had to set their priorities for the water industry in Scotland for the next regulatory control period.

Customer preferences were gleaned from market research and from responses to the Scottish Executive's consultation document 'Investing in water services 2006-14'. It was important for Ministers to listen carefully to these preferences. However, it was also important to recognise the expertise of the DWQR and SEPA and their understanding of public health and environmental compliance issues. We have sought to establish the lowest reasonable overall cost of delivering the Ministers' objectives.

There have been significant increases in customers' bills in the past few years. In general, customers have accepted that there is a need to invest in our water supply and water environment. However, if promised outputs are delayed this could have an impact on customers because there is a higher risk that an output will not be delivered in full or that it will cost more to deliver. Customers are likely to question why promises of improved service levels have not been delivered when bills have gone up.

We have allowed sufficient capital expenditure to meet the efficient delivery of all of the 'essential' and 'desirable' objectives set by Ministers in their February statement.

We have published the baseline investment programme that has been funded in this draft determination in order to improve transparency. If customers have been told by Scottish Water that levels of service will improve as the result of a particular project, they should be able to check if and when that project has been delivered. This will also help ensure that Scottish Water is accountable for the delivery of agreed benefits to customers and to the environment.

Improvements in customer service

It can be difficult to measure customer service performance. Important factors such as the number of properties at risk of sewer flooding or experiencing water pressure problems require engineering judgements. It can take several years, using a consistent approach to monitoring, before we can measure performance accurately and with confidence.

We only began to collect detailed information on customer service in 2001. The uncertainty relating to this information has made it more difficult for us to set robust targets for improvements in individual measures of level of service. This draft determination does, however, make it clear the overall level of service that we expect Scottish Water to provide to its customers.

Establishing financial sustainability

We believe that the revenue increases that we implemented in the Strategic Review 2002-06 have ensured that we now have a more sustainable industry. The charge caps proposed in this draft determination reflect this more solid foundation.

If customers are to continue to benefit from a sustainable industry, we must ensure that we invest appropriately in water services. This means that a generation should pay the full costs of the service that it receives and should not store up problems for future generations. The move towards a charge setting mechanism that is tied to changes in the regulatory capital value, and to its funding costs, will make this more transparent.

Financial sustainability is critical to the success of the public sector model. In the public sector model, the Government wants best value for money for customers and to ensure that social, environmental and public health policy priorities are delivered.

If customers begin to believe that they are not getting value for money then the public sector model for the water industry in Scotland may become politically unsustainable. The greater the extent of perceived failure, the more difficult and costly may be the corrective actions required.

Rigorous monitoring

It is our role to monitor progress against targets, and to verify that service levels to customers do not suffer as a result of management action to reduce costs.

It is important that we are able to measure levels of service to customers in an objective and consistent way, both now and in the future. This requires us to set out in detail the areas of service that we will measure and how they will be measured. We have endeavoured to ensure that we measure the factors that are important to customers and that customers can understand our analysis of Scottish Water's performance. We outline the regulatory contract that we will be monitoring in this draft determination.

Our work in scrutinising costs and the levels of service delivered is key to our role in ensuring that customers receive value for money on a sustainable basis. We believe that this detailed monitoring ensures that we have fulfilled our statutory duty to have regard to "the economy, efficiency and effectiveness" with which Scottish Water is using its resources.

Customers only pay once for an agreed output

Regulation has introduced much needed transparency to the process of assessing Scottish Water's performance. In the past it was not clear whether customers had received the benefits which were promised and for which they had paid.

We have responded to this risk by developing our performance monitoring significantly in the past three years. Our more detailed monitoring of the capital programme will also ensure that we can manage the transition from the Quality and Standards II to the Quality and Standards III period effectively.

Structure of the draft determination and next steps

In this draft determination we present our preliminary conclusions. There will now be a period until 23 September 2005 during which stakeholders can comment on the charge caps that we consider to be appropriate. The final determination of charges will be published at the end of November 2005 by the new Water Industry Commission.

The full detail of this draft determination is presented in the following volumes:

The Strategic Review of Charges 2006-10: The draft determination: Volume 1: The proposed charge caps - an executive summary

The Strategic Review of Charges 2006-10: The draft determination: Volume 2: Introduction and background

The Strategic Review of Charges 2006-10: The draft determination: Volume 3: Our approach to setting charge caps

The Strategic Review of Charges 2006-10: The draft determination: Volume 4: Economic regulation of the public sector water industry in Scotland

The Strategic Review of Charges 2006-10: The draft determination: Volume 5: Financing delivery of the investment objectives of the Scottish Ministers

The Strategic Review of Charges 2006-10: The draft determination: Volume 6: Setting an appropriate level of operating costs

The Strategic Review of Charges 2006-10: The draft determination: Volume 7: Setting charge caps

The Strategic Review of Charges 2006-10: The draft determination: Appendices

Chapter 1
Introduction

Introduction

In the Strategic Review of Charges 2002-06 this Office advised Ministers on the appropriate price limits both for the three water authorities and for the proposed Scottish Water. The current Review, which covers 2006-10, is the first full Strategic Review of Charges to set charge limits for Scottish Water alone.

The three separate authorities remained in existence until Scottish Water was formed under the Water Industry (Scotland) Act 2002 on 1 April 2002. Under sections 21-23 of the Act the functions, property, liabilities and staff of the water and sewerage authorities were transferred to Scottish Water.

Scottish Water remains in the public sector, and is accountable to the Scottish Parliament through the Scottish Ministers. However, its structure and the way it is managed is able to draw on lessons learned from best practice in the private sector. The combination of public sector ownership and a private sector organisational structure has been designed to ensure that the business is as efficient as possible. This is clearly in the interest of all customers.

In May 2004, Ross Finnie, the Minister for Environment and Rural Affairs, wrote to both the Chairman of Scottish Water and to this Office in order to commission work on the Strategic Review of Charges 2006-10.

This was followed in February 2005 with the Ministerial Statement on:

- what Scottish Water was to achieve during the review period 2006-10;
- the principles that this Office 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.

Role of the Water Industry Commissioner for Scotland

Prior to 1999, the Scottish Water and Sewerage Customers' Council represented the interests of water industry customers in Scotland. The Council had responsibility for handling customer complaints, agreeing the scheme of charges for the then three Scottish water authorities, and representing customers' views.

Part II of the Water Industry Act 1999 created the post of the Water Industry Commissioner for Scotland and this Office was established on 1 November 1999. According to the Act, the Commissioner was responsible for regulating all aspects of the economic and customer service performance of the three Scottish water authorities. The Commissioner also took over the responsibilities of the Scottish Water and Sewerage Customers' Council.

The Commissioner is appointed by the Scottish Ministers through the Scottish Executive Environment and Rural Affairs Department. The Commissioner's primary role is to promote the interests of customers of Scottish Water. The Commissioner's duties include:

- advising the Scottish Ministers on the amount of revenue that Scottish Water needs to provide a sustainable service to customers and to fund its investment programme;
- considering and approving Scottish Water's annual scheme of charges;
- investigating customer complaints not resolved by Scottish Water;
- advising the Scottish Ministers on Scottish Water's standards of service and customer relations;
- approving Scottish Water's Code of Practice; and
- providing advice, when requested by the Scottish Ministers, on a range of matters relating to the impact of Scottish Water on its customers.

The Water Industry Commissioner for Scotland has set the following strategic aims:

- to be professional, objective, factual, analytical, transparent and rigorous in the approach to regulation;
- to provide all stakeholders with accurate information about Scottish Water's performance;
- to encourage Scottish Water to become more efficient and sustainable through a clearer understanding of its costs;
- to promote the interests of Scottish Water's customers to ensure that the level of customer service compares favourably with the average in England and Wales; and
- to give credit where there has been good performance and to challenge poor performance, highlighting any shortfalls in levels of service.

The Commissioner is accountable to the Scottish Ministers. As part of this accountability, the Commissioner must draft an annual corporate plan and submit an annual report and accounts. These documents set out:

- the Commissioner's work plans, performance targets and budget projections for a three-year period – this plan has to be approved by Ministers;
- the Office's activities and its progress with the forward programme as set out in the previous year's corporate plan – this report is both published and laid before Parliament.

Persuant to provisions of the Water Industry (Scotland) Act 2002, the three former water authorities merged on 1 April 2002 to form Scottish Water. The Commissioner remained responsible for regulating all aspects of Scottish Water's economic and customer service performance. The role of the Consultative Committees, established in the 1999 Act, was replaced by the Water Customer Consultation Panels.

How the Commissioner's role has developed

Since this Office was created in 1999, the scope of our activities has broadened. In our first years of operation we concentrated on the first Strategic Review of Charges and on collecting the information that was essential to that review. Gradually our ongoing monitoring of Scottish Water's performance has taken on greater significance. This monitoring role ensures that customers receive improved value for money and can have confidence that the benefits of increased investment are realised.

The Water Services etc. (Scotland) Act 2005 further develops the role of this Office. The Act establishes a Commission in place of a single Commissioner with the power to determine charge caps. It also sets up a framework for retail competition for non-household customers. The new Commission will assume the role of licensing authority. We discuss these changes in detail in Chapter 3.

The regulation of Scottish Water

Scottish Water is a monopoly business operating in the public sector. Regulation therefore plays an important role in protecting customers' interests and promoting efficiency within the business.

Effective economic and customer service regulation requires a process that is robust, transparent and verifiable by audit. We have established a detailed framework which allows us to regulate Scottish Water in a way that protects customers' interests and allows us to provide sound advice to Ministers.

The process involves gathering and analysing a wide range of financial, asset and customer information from Scottish Water. By analysing this information we can comment objectively on Scottish Water's performance and can make comparisons with other water and waste water companies. Our approach is similar to that employed by other regulators, including Ofwat, which regulates the water and waste water companies in England and Wales.

Our objective in using comparative analysis is to promote continued improvements in customer service standards, environmental and public health compliance and financial performance. Experience from other utilities and from the water industry south of the border has shown that this can bring significant benefits to customers and the environment through lower costs, improved environmental and water quality standards and better customer service.

Economic regulation

At the start of each regulatory control period, we have to complete a Strategic Review of Charges. The Scottish Ministers can commission such a Review whenever they consider it appropriate. The Review determines the level of revenue required by Scottish Water in order to be able to finance its core functions of providing water and sewerage services on a sustainable basis.

The cost of the capital investment programme that is decided by Ministers following public consultation is assessed, as is the operating expenditure required for each year of the review period. The Review takes full account of the efficiencies that Scottish Water can be expected to make. The Strategic Review of Charges therefore represents the baseline against which Scottish Water's performance can be measured.

During the regulatory control period we monitor Scottish Water's performance. Each year, we collect a significant amount of information from Scottish Water, most of which is information that is required for the day-to-day management of the business. We analyse the financial and economic information that we receive and use this to monitor and report on performance in two reports (the Investment and Asset Management Report and the Costs and Performance Report).

Customer service regulation

Customer service regulation of Scottish Water involves ongoing monitoring of Scottish Water's performance on customer service measures. Once again, this is achieved through our review, analysis and reporting of customer service information that Scottish Water submits to us. We can also make use of information from our investigation of complaints (see below) and from our programme of consultation.

We work with the WCCPs to ensure that Scottish Water offers an appropriate level of service to customers. The WCCPs have a remit to represent customers and can make representations to the Commissioner.

An important aspect of customer service regulation is the approval of Scottish Water's Code of Practice. Scottish Water has an obligation to produce a Code of Practice under section 26 of the Water Industry (Scotland) Act 2002. The Code of Practice provides information on the standards of service that customers can expect and on how Scottish Water will deal with customers.

Once Scottish Water has prepared a draft of its Code of Practice, it submits the draft to this Office. The Commissioner consults with the WCCPs and compares the service levels proposed by Scottish Water with those offered by other water and utility companies. Comments and suggestions are provided to Scottish Water and new drafts are reviewed until a final version is agreed.

Until the provisions of the Water Services etc. (Scotland) Act 2005 are implemented, the Water Industry Commissioner for Scotland has a statutory duty to investigate complaints. We investigate written or telephone complaints that we receive direct from customers, as well as complaints referred to us by the Convenor of the WCCPs.

In some cases the complaint may be dealt with by providing an explanation to the customer about how a decision has been reached or by confirming that Scottish Water has carried out an appropriate process or procedure. In other cases we may have to intervene in order to help resolve a dispute between Scottish Water and the customer.

The Strategic Review of Charges 2002-06

In August 2001, our Office was commissioned to carry out the Strategic Review of Charges 2002-06 by the Minister for Environment and Rural Development, Ross Finnie, MSP. At that time, the Parliament was considering proposals from the Scottish Executive to merge the three water authorities and create Scottish Water. It was therefore necessary for us to advise on revenue caps both for the proposed Scottish Water and for the existing three authorities. Our methodology needed to allow stakeholders to make objective comparisons of the implications for customers of the merger.

In 2001 we said that if the industry met the challenges it faced, and there was not a significant increase in the investment programme, then by 2006 customers could enjoy an environmentally and financially sustainable service without a further real increase in their bills. Scottish Water has made a good start in meeting the challenges that were set in the 2002-06 Strategic Review. It is this significant improvement in performance that underpins the positive price outlook contained in this draft determination of charges.

The creation of Scottish Water has brought benefits to customers throughout Scotland. Customers in all parts of Scotland are now paying less than they would have paid if Scottish Water had not been established. The trend of worsening efficiency in the Scottish water industry over past years has been halted, and the rate at which efficiencies are being made is beginning to improve significantly. Notwithstanding its progress to date, Scottish Water has more to do if it is to meet the service and cost levels of the industry in England and Wales.

The Strategic Review of Charges 2006-10

Regulation seeks to ensure that customers enjoy a value for money service. Customers should be able to count on a supply of high-quality, wholesome drinking water, continuing improvement in our water environment, and a service that is provided at a reasonable cost. It is the job of the regulators to ensure that customers enjoy a 'silent' service, ie one that they can take for granted.

Customers will rightly expect us to have built on progress since the last Strategic Review of Charges. We have set prices that are sufficient, but no more than sufficient, to fund the essential and desirable investment specified in the Ministerial Guidance.

The Better Regulation Task Force principles

We are committed to the Better Regulation Task Force[4] principles of accountability, transparency, proportionality, consistency and targeting. As such, we have published all of the key information submissions that this Office has received from Scottish Water, as well as the tools that we have used to complete our analysis, including our financial and tariff basket models.

We have also published six consultation and information documents to support our Strategic Review of Charges 2006-10. In these documents we explained in detail the proposed methodology for the Strategic Review and invited stakeholders to comment on our methodology. The documents we published are shown in Table 1.1.

Table 1.1: Consultation documents published

Volume	Title	Date published	Date for responses
1	Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges 2006-10	22/07/04	29/09/04
2	Our work in regulating the Scottish water industry: Background to and framework for the Strategic Review of Charges 2006-10	13/08/04	29/09/04
3	Our work in regulating the Scottish water industry: How we intend to set prices in the Strategic Review of Charges 2006-10	22/09/04	29/10/04
4	Our work in regulating the Scottish water industry: How we intend to assess operating efficiency in the Strategic Review of Charges 2006-10	07/10/04	05/11/04
5	Our work in regulating the Scottish water industry: The scope for capital cost efficiency	17/12/04	19/1/05
6	Our work in regulating the Scottish water industry: a summary	17/12/04	n/a

4 The Better Regulation Task Force was established in September 1997. It is an independent body that advises Government on action to ensure that regulation and its enforcement accord with the five Principles of Good Regulation.

The six volumes are available on our website (www.watercommissioner.co.uk). We notified the following that the documents had been published:

- 193 individuals (including academics and our professional advisors); and
- 137 organisations (including local authorities and water companies).

We summarised the issues raised by consultation responses in May 2005: 'Our work in regulating the Scottish water industry: the Water Industry Commissioner's response to issues raised by respondents to the consultation on methodology'. This also highlighted where our methodology had changed in light of the responses and where further analysis was required.

In order to support the consultation process we also held a number of stakeholder information days and workshops. These were outlined in Volume 1 of our methodology consultation and a summary of the issues raised can be found on our website.

The financial model

We used a financial model to establish the appropriate level of revenue for Scottish Water to deliver outputs specified in the Ministerial Guidance[5]. This model allowed us to ensure that an appropriate balance is struck between current and future customers. We also used the financial model to protect customers from unnecessary fluctuations in their charges.

In common with other regulators, we used a financial model that allows different cost, investment and timing scenarios to be assessed. This ensures that we have set charges at the lowest sustainable level. The financial model was conceived and developed using in-house resources and was subject to extensive external audit. This audit reviewed both the workings of the model and internal processes, such as version control, during the preparation of the draft determination.

The financial model was constructed using Microsoft Excel©[6]. It is available on our website.

Aims of the Strategic Review of Charges 2006-10

The Strategic Review of Charges 2006-10 has followed the terms of the commissioning letter and subsequent Ministerial Guidance very closely. The February Ministerial Guidance set objectives for the water industry. It detailed the investment that had to be delivered and the principles of charging to be employed in setting charge caps. This draft determination builds on the strong foundation for the industry that was created by the previous Review. In preparing this Strategic Review of Charges, we have the benefit of four years of detailed asset, cost and customer information. We have also sought to learn from the experience of the last Strategic Review and from the comments that we have received from individual customers and stakeholder organisations.

The principal aim of this Strategic Review of Charges 2006-10 is to set charges at the lowest overall level that is consistent with the delivery of the Ministers' objectives for the industry.

Structure of the draft determination

The draft determination is set out in seven volumes. These are:

The Strategic Review of Charges 2006-10: The draft determination: Volume 1: The proposed charge caps - an executive summary

The Strategic Review of Charges 2006-10: The draft determination: Volume 2: Introduction and background

The Strategic Review of Charges 2006-10: The draft determination: Volume 3: Our approach to setting charge caps

The Strategic Review of Charges 2006-10: The draft determination: Volume 4: Economic regulation of the public sector water industry in Scotland

5 Ministerial Guidance, February 2005 available at www.watercommissioner.co.uk
6 Stakeholders who wish to download the model will require a licensed copy of Microsoft Excel©.

The Strategic Review of Charges 2006-10: The draft determination: Volume 5: Financing delivery of the investment objectives of the Scottish Ministers

The Strategic Review of Charges 2006-10: The draft determination: Volume 6: Setting an appropriate level of operating costs

The Strategic Review of Charges 2006-10: The draft determination: Volume 7: Setting charge caps

The Strategic Review of Charges 2006-10: The draft determination: Appendices

Structure of this volume

Chapter 2 of this volume examines the role of regulation in delivering value for money for customers. Chapter 3 covers changes in the regulatory framework. Chapter 4 discusses the implementation of the Water Services etc. (Scotland) Act 2005. Chapter 5 looks at other inputs to the Strategic Review of Charges 2006-10. In Chapter 6 we examine the implications of the changing regulatory framework and Chapter 7 highlights some of the critical issues that the Strategic Review of Charges has addressed.

Chapter 2
The role of regulation

Introduction

Monopolies can exist in both the public and private sectors. They can also exist at an international, national or local level. In theory, a monopoly exists when there is a single supplier to a defined market. In practice there are very few examples of such pure monopolies. An effective monopoly is present when most, if not all, customers do not have any real choice and when the dominant market supplier determines the terms and price of supply.

The limited options that exist for customers in Scotland to make arrangements for their water or waste water that are separate from the public network do not substantially alter the extent of Scottish Water's monopoly. Similarly, in England and Wales, although an industrial or commercial customer in one area can request a service from a supplier in an adjoining area, in most cases this is not economically viable.

The purpose of regulation is to seek to ensure that such monopoly businesses act in the customer interest. Regulators can act to encourage the supplier to provide a better level of service to customers and/or to reduce costs while maintaining the level of service. In practice, regulators seek to balance improvements in the level of service to customers with the costs of such improvements.

The role of customer service regulation

Scottish Water's customers are concerned not only about the price they pay for water and sewerage services, but also about the quality of service they receive. It is the combination of price and this quality of service that determines whether customers receive value for money from Scottish Water.

There are many different aspects of Scottish Water's quality of service. Some of these relate to operation of the network; for example, how frequently supply is interrupted and the quality of the water delivered. Others relate to the interaction between Scottish Water and its customers; for example, the time taken to respond to billing enquiries or the time taken to respond to a complaint. Regulation must take account of all aspects of quality of service.

In a competitive market, firms compete with each other in terms of price and quality. In some markets, firms occupy niches such that customers have a choice of products or services that are low cost and low quality, of average cost and of average quality, and of high cost and of high quality. Customers will choose the cost-quality combinations that match their preferences. A firm operating in a competitive market has to ensure that the quality of the good or service it provides is consistent with the price of the good or service.

Where prices are regulated the company may have an incentive to meet cost reduction targets by reducing quality. For example, in order to meet operating cost targets a water company could reduce maintenance activity and allow the network to deteriorate. Alternatively, it could reduce the capacity for handling billing contacts or other enquiries and allow performance in these areas to worsen. Although the cost reduction target may be met this does not constitute an improvement in efficiency. Improved efficiency implies either a higher quality output for the same price or the same quality output for a lower price.

In a regulated market, the regulatory framework must therefore ensure that the level of service is appropriate.

Regulation can provide an incentive for the regulated firm to improve the quality of the service it provides. It can do this directly by setting targets for different elements of service quality and measuring performance against those targets. However, the regulator would require a considerable amount of information in order to set targets for each element of service quality. The regulator would also require information about the level of service quality that is possible for any particular level of cost, and about customer priorities between the different aspects of customer service. Such an approach would require a significant increase in the information collected from the regulated company.

Rather than setting targets for each aspect of service quality, a regulator may compare actual performance against other similar companies ('comparative competition'), and highlight areas where performance could be improved. The regulator may then monitor performance and report on how well the company is performing against the areas identified for improvement. Public comment on performance can often encourage a regulated company to seek to improve in either absolute or relative terms.

The role of economic regulation

Network utility industries tend to be monopolies because the cost to replicate the network would be excessive. Economists describe them as involving a significant 'natural monopoly' element. A natural monopoly refers to the situation where there is only one firm supplying a product in the market, but this is not the result of the firm's behaviour. Instead, it arises because it is the sensible way to organise the industry and it is in the best interests of customers to do so.

The reason that it is sensible to organise the industry in this way is because it is cheaper for one firm to supply the whole of the market than for two or more firms to share the market. For example, a single firm may have costs of £2 million to supply the whole market, whereas if two firms shared the market each may have costs of £1.5 million. It follows that if there were a single firm in the market customers would have to pay £2 million in charges to cover costs, whereas if there were two firms in the market customers would have to pay £3 million in charges. In such a situation the single firm is benefiting from economies of scale.

However, the behaviour even of natural monopolies may work against the customer interest if unchecked. There are two ways in which this might happen.

First, if the service is an essential service and the customer has no choice about where to purchase it, the monopoly has an incentive to charge an excessive price and to make excessive profits. This type of behaviour is known as monopoly pricing. Since the product is essential, the firm can raise its price without demand for the product falling too far. The firm's profits will therefore increase as it raises its price. From the customer's point of view there is little alternative to buying the product, regardless of the price. Water and power are typical products of this type.

Second, in the absence of competition the monopoly faces no incentive to innovate and improve its efficiency over time. From the point of view of the firm a failure to innovate and improve efficiency will have little or no implications for the size of the market that it serves or the level of profit that it earns. Compared with a competitive market, the industry will tend to stagnate.

In the water industry south of the border Ofwat has a duty to ensure that an efficient business can fund its operations. Customers desire a service that is provided on a sustainable basis. The owners of the privatised business are required to ensure that management meets or exceeds the targets set by the regulator. Such out-performance is the only way to ensure that the owners of the business will receive a higher return on their investment.

In the public sector, regulation of the water industry focuses on ensuring that the Government's environmental and public health objectives are delivered at the lowest reasonable overall cost.

In both the public and private sector, economic regulators[7] seek to establish a tight budgetary constraint on the regulated body. In other words, clear statements are made about the outcomes for customers that the body must deliver **and** about the amount of money that can be spent. This can be achieved by fixing the maximum return available (unless targets are beaten) or by limiting the total cash funds that may be consumed.

This tight budgetary constraint should focus management attention on delivering ongoing improvements in value for money to customers. This explains why regulators publish regular assessments of the financial performance of the companies or organisations they regulate. Of course, regulators will also monitor the outcomes for customers very carefully. It is not in customers' interests if budgetary pressures result in corners being cut either in customer service or in the way the asset base is maintained. In this regard it is important to be clear about what regulators mean by efficiency: we recognise efficiency when an

7 Regulation of a public sector corporation is not unique. Postcomm fulfils a similar role to this Office in its regulation of Royal Mail. The Civil Aviation Authority also has economic regulation responsibilities for the locally owned Manchester Airport.

improved or at least equivalent level of service has been delivered to customers at a lower cost.

In a competitive market, companies face similar tight budgetary constraints in that they have to match their costs to the revenue they can win from customers. Regulation consequently provides a proxy for the discipline of competition.

Incentive-based regulation ensures that there is continuous pressure on Scottish Water to meet these targets.

Our incentive-based approach in this draft determination has been developed to ensure that we encourage efficiency in the delivery of investment. The water and sewerage industry is an asset-intensive industry that relies on expensive assets with very long lives. If the industry is to provide a reliable service, at the level of quality that is expected by customers, it is important that regulation should provide incentives to invest and should avoid producing disincentives to invest.

How economic regulation in the public sector is different

All UK economic regulators adopt this incentive-based approach to determining prices. The analysis is complex and thorough, but essentially the regulator analyses the scope for improvement in performance.

Past performance is analysed across the sector[8] and an initial benchmark set. The regulator then decides how much further improvement in performance is reasonably achievable by an efficient company during the forthcoming regulatory period. This then determines the target that is to be set for all companies in the sector. A determined management may out-perform the targets and in doing so will benefit the shareholders (private companies) or customers (Glas Cymru), but such out-performance will also raise the level of performance expected at future reviews. It is this ratchet approach that has resulted in the significant efficiency gains south of the border.

Regulators normally rely on shareholders to exert pressure on management to out-perform efficiency targets. More recently, however, the creation of not-for-dividend companies (such as Glas Cymru[9] and Network Rail) and the introduction of regulation to public sector companies (such as Scottish Water and Royal Mail) has led regulators to refine their approach.

Regulators have, in general, concluded that incentive-based regulation can be used to regulate the not-for-dividend companies. Obviously they can no longer rely on shareholder pressure to improve value for money to customers. This has required regulators to focus on corporate governance and incentive frameworks. Ofwat set several conditions when it approved the establishment of Glas Cymru. These conditions included the creation of transparent incentives that align the interests of management and those of customers. The Department for Transport and HM Treasury established a similar framework for Network Rail.

PostComm uses incentive-based regulation but does not currently use the regulatory capital value method of price setting. The Royal Mail is a service rather than an asset based industry. The regulatory capital value approach to price setting is likely to be more appropriate for asset based industries.

In regulating the water industry in Scotland, we want to ensure that we take full advantage of the relatively cheap government borrowing that is available; at the same time we are mindful not to reduce the impact of the tight budgetary constraint on current management or to increase bills for future customers disproportionately.

In the private sector, there exists a contractual relationship between the Government and the private utilities. Each utility has a licence to operate that requires it to meet standards of operation that are considered appropriate in terms of social, environmental, and public health policy objectives. The economic regulator takes account of all such issues that arise from legislation or other government guidance when determining the outputs that are to be delivered, and then sets the price limits accordingly. Thereafter, he depends on shareholder pressure to ensure that these are delivered as efficiently as management can achieve, and simply has to monitor performance to ensure that the defined standards are properly achieved.

8 For Scottish Water we look at the water and sewerage industry both north and south of the border.
9 Glas Cymru is a not-for-profit company, limited by guarantee, which acquired Welsh Water in May 2001.

In the public sector, the regulator has to assess the lowest reasonable overall cost of delivering the objectives set by the Scottish Ministers. He cannot rely on the presence of market forces to deliver efficiency.

Regulation of Scottish Water in the public sector

There is a consensus that water should remain in the public sector in Scotland. In this context, our role is to set a framework within which Scottish Water can improve its efficiency and consequently the value for money it provides to customers. This has required us to consider firstly the issues of incentives and governance, and secondly the appropriate level of borrowing.

There is much to be gained by addressing these issues. If a public sector organisation can match the level of efficiency of investment and service delivery that is achieved by the private sector, customers of that public sector supplier could expect sustainably lower prices than those that could be offered by a private sector operator. This is because the public sector is able to access capital at lower cost.

There can be no doubt that customers benefit significantly from Scottish Water's ability to access public government loans. These government loans attract interest rates that are lower than the cost of commercial debt of similar term length for the water and sewerage companies in England and Wales. This relatively expensive private debt is, moreover, considerably cheaper than equity. The cost of capital for a company south of the border is therefore much higher.

Although direct comparisons can be difficult because of the existence of equity and the duration, base rate and tax issues associated with private debt, a comparison with Ofwat's allowed cost of capital helps to illustrate this general point.

Ofwat's allowed cost of capital for the period 2005-10 is 5.10% real post-tax for the water and sewerage companies. Government loans to Scottish Water since its creation attracted nominal pre-tax interest rates of between 3.3% and 4.9%. The weighted average interest rate for new loans taken out by Scottish Water in 2002-04 was 4.16% nominal pre-tax. We have allowed Scottish Water a maximum 4.6% nominal pre-tax cost of capital[10]. This would be equivalent to approximately 1.4% real post-tax on the debt/customer retained earnings split that exists at the start of the 2006-10 regulatory control period. We have provided Scottish Water with an additional allowance to cover its embedded debt.

We estimate that Scottish Water's customers probably benefit by approximately £100-140 million a year, because of the saving on the annual cost of capital of around 3.7%. We have calculated this on the basis of the initial regulatory capital value. This saving is likely to increase over time if Scottish Water continues to enjoy access to public borrowing.

It is important to note that this cost benefit will only truly be realised by customers if they are not exposed to operational risks and if the service is delivered efficiently.

However, as regulator we must take into account that customers of Scottish Water are more immediately exposed to the financial risks of the business than customers in England and Wales. This is because there are no private equity shareholders. In the event of an external shock or under-performance by the business a private utility can:

- withhold dividend payments to shareholders;
- seek a rights issue; and
- obtain debt in the private markets.

Scottish Water, by contrast, must either:

- seek unplanned public expenditure in the form of a loan; or
- increase charges to customers immediately.

The presence of private equity acts as a significant shock absorber, so protecting customers in England and Wales. An example to illustrate this point is the costs of around £250 million that resulted from the drought in

[10] The customer retained earnings component (the regulatory capital value less outstanding debt) is remunerated at 3.22%. This is equal to the post-tax cost of debt. We discuss this in more detail in Chapter 17 of Volume 5.

1995, which had to be absorbed by the equity holders of Yorkshire Water. Moreover, Ofwat cut the prices that Yorkshire Water could charge to customers, as a result of its poorer service, and as a result further limited the return available to shareholders.

The private sector provides a further level of risk management that benefits customers. Strong incentives help to reduce customers' exposure to financial risk. The commercial interests of the company are served by ensuring that management takes action to minimise the impact of external shocks on the business. Even more importantly, there are commercial incentives to out-perform efficiency targets, which benefit customers in the medium term[11]. In other words, tight budgetary constraints apply a degree of financial discipline to the business, so that there are 'sticks' as well as 'carrots'.

However, we should emphasise that it is not necessary to adopt an equity-funded model in order to manage financial risk. Glas Cymru has established a structure that protects customers from financial risk, without a traditional shareholder acting as a 'shock absorber', since total debt is less than its regulatory asset value.

In 2001 Glas Cymru purchased the assets of Welsh Water for 95% of its regulatory capital value. The lower purchase price, a clear ring-fence on activities, and transparent incentives that are published in advance have all contributed to a lower cost of capital. Glas Cymru is believed to have one of the lowest costs of capital in the water industry south of the border. This results from its focus on the core business and from the fact that it does not use equity capital.

Glas Cymru's average cost of debt is approximately 6.8%. This is equivalent to 4.76% post-tax. The budgetary constraints are still tight and the debt provided by private banks is at risk if there is an unforeseen shock. However, customers are protected because the banks are committed in advance to making additional funds available if there is such a shock (although there are likely to be governance implications for the organisation). Customers would not suffer (assuming that proper management could have avoided or limited the shock) since Ofwat would be under no obligation to increase the cash value of the return on capital allowed to Welsh Water as a consequence of any unforeseen shock.

In May 2005 we wrote to the Deputy Minister for Environment[12] to outline our proposals to manage these risks. We recognise the risks borne by the customers of Scottish Water. We propose to reflect this risk by, in the event that Scottish Water out-performs its regulatory contract, commenting on the scope for Scottish Water to accept a lower charge cap in subsequent years of the regulatory control period. At the same time, in line with the Ministerial Guidance we have ensured that the financial strength of Scottish Water (as measured by the debt to RCV ratio) continues to improve gradually. Our proposals are discussed in more detail in Chapters 6 and 7 of Volume 4.

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 out-perform efficiency targets, in the same way as a regulated company that is subject to shareholder pressure, it would have needed to modify the approach to determining Glas Cymru's price settlement. We present a detailed case study of Glas Cymru in Volume 4 of this draft determination. Ofwat paid particular attention to the incentive framework that was introduced for Glas Cymru's senior managers.

At present there is no equivalent incentive system in place for Scottish Water's management. Managerial incentives are not linked in any transparent way to the organisation's performance against economic, public health or environmental targets.

For incentive-based regulation to work, it is essential that managerial incentives are available for out-performance of targets, not for progress towards them. We addressed this issue in our second open letter to Scottish Ministers.

11 Out-performance in a regulatory period can be retained by the company for five years. This benefit is then transferred to customers.
12 This letter is available on our website.

It is at least equally important that, in future, customers are not asked to pay twice for the agreed level of service. If Scottish Water does not meet the level of performance set out in its regulatory contract, it will be for Scottish Ministers (as the de facto owner) to decide on an appropriate course of action. In our view, their response should not adversely impact on customers.

How an economic regulator ensures that customers receive value for money

Setting an appropriate tight budgetary constraint

We have already discussed the importance of the tight budgetary constraint in both the public and private sectors. In other words, clear statements are made about the outcomes for customers that the body must deliver and about the amount of money that can be spent.

Setting transparent targets for operating and capital costs that are challenging but achievable

Our ability to maximise value for money to customers depends in large part on setting challenging but achievable targets on financial performance. In 2001, we set challenging efficiency targets for Scottish Water. By 2006, we expect that Scottish Water will have reduced its inherited operating costs by some £145 million annually in real terms. Customers' bills will consequently be around 15% lower than they would otherwise have been.

Notwithstanding the cost reductions already achieved by Scottish Water, our analysis has demonstrated that there is still considerable scope for further improvement after 2006. We have therefore set Scottish Water the challenge of further reducing its level of operating and capital expenditure costs. We believe that this regulatory contract may be challenging but that it is achievable. It will ensure that prices paid by customers are as high as they need to be to ensure that the Ministers' objectives for the industry can be delivered – but no higher than they need to be. We have endeavoured to ensure that the regulatory contract is as clear and transparent as possible. This should encourage stakeholder confidence in the reported performance of the industry.

Limits to economic and customer service regulation

Limits to economic regulation

As discussed, the purpose of regulation is to seek to ensure that monopoly businesses act in the customer interest. Regulation seeks to capture, for the customer, the benefits of economies of scale enjoyed by a natural monopoly and to avoid the excessively high prices and the tendency to stagnate that characterise unconstrained monopolies. However, there are limits to the ability of regulation to perform this role.

The effectiveness of regulation will depend on the quantity and accuracy of information available to the regulator and the consistency and clarity of the policy framework within which he or she operates.

In common with Ofwat, we collect information from Scottish Water in standard formats. Each request for information is issued with a clear explanation and detailed definitions of what is required. Recently, we agreed with the Scottish Executive and Scottish Water that we should appoint a Reporter to audit the consistency and completeness of information provided to us. This brings the Scottish industry broadly into line with the situation south of the border.

Regulators use information from both the regulated company and other sources. There is always an asymmetry between the information that the regulator requests and the far greater detail of information held by the regulated company. We make extensive use of information collected by Ofwat to ensure that we can form an accurate picture of performance.

Regulation of network industries takes place within a complex policy framework. It is important that the regulator benefits from clear guidance in order to be able to strike an appropriate balance between potentially competing priorities (namely, low bills or additional environmental improvements).

For the water industry south of the border, Ofwat has used an incentive-based framework to improve the value for money received by customers. All of the regulated water companies have an incentive to invest because they are guaranteed a return on efficient investment and are allowed to keep the benefits of out-performance of regulatory targets for five years. Ofwat has also made extensive use of comparative competition to ensure that the performance of each company (in terms both of costs and levels of service) relative to its peers is clear.

Ofwat publishes its performance monitoring assessments. These include 'league tables' for customer service and relative efficiency. Unless a company is content to see itself at the bottom of the league, it has an incentive to innovate and improve its performance. This regulatory regime therefore does mimic a genuinely competitive market.

Limits to customer service regulation

Effective customer service regulation is dependent on good quality information on customer service performance. Reliable information about the quality of customer service is more difficult to collect than information about costs, customers or assets. Much of the information relies on works management reporting, statistical analyses and complaints. Moreover, performance in individual years may be adversely impacted by abnormal events.

In Scotland we do not yet have as accurate a picture as we would like of the quality of service performance and how it compares with performance south of the border.

In England and Wales, information about the level of service to customers has been collected for a number of years. Regulation through comparative competition and the audit of information by Reporters has ensured that this information now accurately reflects the service provided to customers.

By contrast, in Scotland we have only relatively recently begun to collect information about the level of service to customers in a consistent way. Over the next few years we would expect this information to become much more reliable so that more detailed comparisons with levels of service south of the border will be possible.

Types of regulatory frameworks

There are three main regulatory models:

- **Cost-of-service (rate of return) regulation:** in this model the regulator sets the return that can be earned on investment by companies. This enables a company to recoup, at a set rate, the costs and investments that it has put in to deliver the services provided these are in line with the agreed budget. Cost-of-service regulation includes no incentive to minimise costs or to avoid the 'gold-plating' of assets.

- **Price cap regulation:** price cap regulation (RPI-X) sets the maximum prices that companies can charge for their services for a period of years. This provides an incentive to a company to improve its efficiency. This is because it has to drive down costs in order to improve returns to the shareholder or, in the case of Glas Cymru, deliver the rebates to customers' bills that were promised by management.

- **Franchise regulation:** under franchise regulation, the regulator invites companies to bid for the right to provide services to the public. The company that offers the best price-quality package wins the bid and will contract to provide the services at a certain price and to a defined quality standard.

We believe that price cap regulation is the most applicable to the Scottish water industry's current position. The UK regulators all use this approach. Using this approach in Scotland will allow more direct comparison with the industry in England and Wales. This is important as it is through benchmarking Scottish Water's performance with the performance of other water companies that we can determine the extent of efficiencies that are possible.

RPI-X incentive framework and benefit sharing

In the context of regulated utilities, incentive regulation has been defined as "the use of rewards and penalties to induce the utility to achieve desired goals where the utility is afforded some discretion in achieving goals"[13]. In the case of the water industry, the "desired goals" would include:

- keeping prices to customers as low as possible;
- meeting environmental and water quality objectives;
- delivering the required investment programme;
- maintaining the long-term sustainability of the industry; and
- meeting customer service targets.

Some commentators have suggested that RPI-X promotes short-term planning by utilities instead of encouraging the long-term investment planning that could sustain efficiency improvements and would be more beneficial to customers. We agree that there is a risk that regulated companies are likely to maximise their short-term performance. It would be desirable to ensure that regulated companies planned for the long term. We consider that transparent and consistent regulation are likely to be at least as important in ensuring companies have the confidence to plan for the long term as other potential regulatory actions.

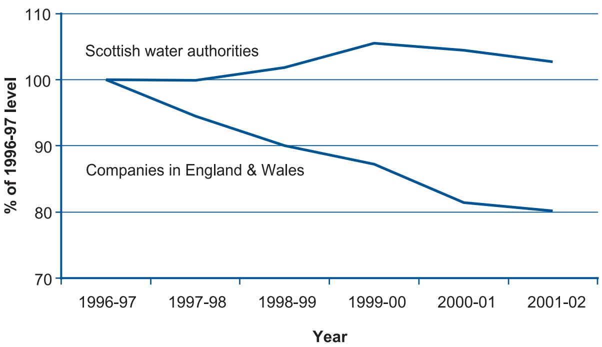
However, in developing our approach to the scope for capital expenditure efficiency, we have been able to develop the standard incentive-based regulation approach in order to balance the various stakeholder interests that impact on the public sector water industry. In particular, our approach takes account of the fact that we have an owner who would tend more towards utility maximisation than profit maximisation[14].

How economic regulation of the Scottish water industry has already benefited customers

Track record of the three former water authorities

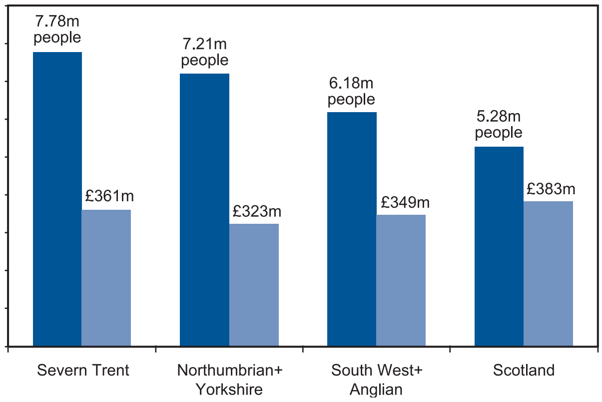
In their last years of operation the three former water authorities were becoming less efficient at a time when the industry in England and Wales continued to improve its performance. This is illustrated in Figure 2.1.

Figure 2.1: Trends in base operating costs of predecessor authorities 1996-97 to 2001-02



In the Strategic Review of Charges 2002-06 we used Figure 2.2 to illustrate the gap in the operating cost performance of the industry in Scotland and south of the border.[15]

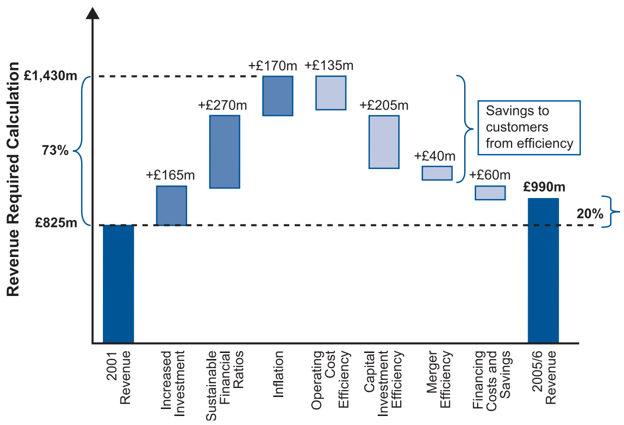
Figure 2.2: Comparison of operating expenditure and population served 1999-2000



13 Lewis, Tracy and Garmon, Chris 'Fundamentals of incentive regulation'. PURC/World Bank International Training Program on Utility Regulation and Strategy, June 1997.
14 A utility maximising owner seeks to maximise priorities other than profit eg public benefit or environmental benefit.
15 This comparison did not take account of any impact of the smaller water-only companies that operate in many of the ten sewerage regions.

If we had not identified the scope for efficiency, prices would have increased by an even greater percentage during the last regulatory control period, as Figure 2.3 shows.

Figure 2.3: The scope for efficiency and other savings



The scope for efficiency that we identified reduced the required increase from some 73% to a still significant, but more acceptable, 20%.

Performance of Scottish Water

The actual level of operating costs inherited by Scottish Water was some £20 million higher than expected when we completed the Strategic Review of Charges 2002-06. Scottish Water will have cut annual operating costs by some £145 million in real terms during the regulatory control period 2002-06. Scottish Water has done well over the last four years and these savings will continue to benefit customers in the period 2006-10. Total real operating cost savings will be greater than projected in the Strategic Review of Charges 2002-06.

We have also successfully established a baseline for the level of customer service provided by Scottish Water to its customers. In future years we will be able to report, in an increasingly reliable way, on the underlying improvement in Scottish Water's customer service performance.

Conclusion

It is clear that the introduction of economic and customer service regulation has begun to deliver benefits to customers. Much, however, remains to be done. We believe that the changes to the regulatory framework that have been introduced in the last three years will strengthen regulation and ensure that customers benefit from improved value for money more quickly than would otherwise have been possible.

Changes in the regulatory framework are described in more detail in Chapter 3.

Chapter 3
Changes in the regulatory framework

Introduction

The regulatory framework for the water industry in Scotland is broadly similar to that in England and Wales. There are separate organisations that are responsible for customer service and economic regulation, environmental protection, and safeguarding public health.

Regulation of the water industry in Scotland has developed significantly in recent years. This has brought major improvements in transparency and accountability for Scotland's water industry, to the benefit of all stakeholders. We described the role of the Water Industry Commissioner for Scotland in Chapter 1. The other principal agencies that are responsible for regulating Scottish Water and representing stakeholders' views are described below.

The Water Customer Consultation Panels

The Water Industry (Scotland) Act 2002 created five Water Customer Consultation Panels across Scotland to represent the views and interests of customers of Scottish Water in the areas covered by the Panels. The Panels are independent of Scottish Water and of other agencies, including the Water Industry Commissioner. These five Panels replaced the three Consultative Committees, chaired by the Water Industry Commissioner, that were established by the 1999 Act.

Each Panel is required to maintain close contact with customers and representative organisations through meetings and consultations, and by publishing reports and other documents.

The Panels establish contact with customers (household and non-household), local authorities and community groups across Scotland. They also liaise with large and small businesses, commission reports and undertake market research in order to establish customers' views and concerns.

The Drinking Water Quality Regulator

The role of the Drinking Water Quality Regulator for Scotland was established by the Water Industry (Scotland) Act 2002. The primary purpose of the drinking water quality regulations is to protect public health. The DWQR provides an independent check that Scottish Water is complying with the drinking water quality regulations. These regulations include both European Union and other statutory standards. The Act provides the DWQR with extensive powers to:

- acquire information;
- conduct investigations; and
- take enforcement action should this prove necessary.

The Scottish Environment Protection Agency

The Scottish Environment Protection Agency was established by the Environment Act 1995 and became operational on 1 April 1996. SEPA is responsible for a range of activities, including the following:

- Regulating discharges to rivers, lochs, estuaries and coastal waters from industry, sewage treatment works, fish farms, septic tanks, etc.
- Controlling pollution from waste management activities, including licensing storage and disposal of waste and regulating landfill sites.
- Protecting and improving the water environment, including River Basin Management Planning under the Water Environment and Water Services Act.

Although each of these regulatory and representative bodies is independent, with different statutory duties, they work in a co-ordinated way to promote the interests of all stakeholders in the water industry in Scotland. The best example of this co-ordination is the Quality and Standards process. This process, which is led by the Scottish Executive, defines the investment needs of the water industry in Scotland.

The Strategic Review of Charges 2002-06

Regulation of the water industry in Scotland was new in 2001 and our approach to the Strategic Review of Charges 2002-06[16] was tailored to take account of the information that was available at that time. We were required to consider the revenue requirements of the three authorities and the proposed Scottish Water. This included all of the activities of the authorities, even those that were not essential to the provision of water and sewerage services.

One important early conclusion of the Strategic Review of Charges 2002-06 was that there was considerable scope for efficiency. It also quickly became clear that there was limited scope for significant further borrowing if the charge levels faced by future customers were not to be compromised.

The opportunity for efficiency

We used benchmarking to establish the potential scope for efficiency in both operating and capital costs. Our benchmarking used the information that we collected from the industry in regulatory returns and also information about the companies south of the border that had been collected by Ofwat.

The first step was to assess a level of base operating costs. This is the level of costs that would be required simply to maintain the current level of service. The base level of operating costs is established after adjustments for one-off items or events. Examples include the costs of dealing with the 'millennium bug' or unusual weather conditions. Costs can increase if justified by an improvement in the level of service or by the number of customers served.

Efficiency targets are applied to both the base level of operating costs and to any additional operating costs allowed for improvements in the level of service to customers. We did not take account of the poorer level of service provided to customers in our assessment of the relative efficiency of the water industry in Scotland. We allowed only new operating costs that had not already been factored into the Ofwat econometric models[17].

We set the actual operating cost efficiency targets relative to the expected level of efficiency of the comparator companies in 2005. There was a clear gap in efficiency between the industry in Scotland and the comparator companies. We therefore sought to establish an appropriate target that would be challenging but achievable. To establish such a target we looked at the performance of the companies relative to the leading company over a five-year period. We observed that, on average, a company closes 85% of the gap to a leading company during a five-year regulatory period. On this basis, we decided that an appropriate and achievable target was that the industry in Scotland should close 80% of the gap to the comparator companies by 2006. The efficiency target was set as a percentage reduction in the base level of costs. We assumed (as does Ofwat) that a company should deliver an appropriate level of service to customers for the benchmark level of operating costs.

Efficiency in capital expenditure is more difficult to assess and to monitor than efficiency in operating costs. We divided the planning and delivery of capital expenditure into four distinct areas. The potential for efficiency would therefore be the sum of efficiencies identified in:

- strategic asset management;
- programme planning or investment appraisal;
- procurement; and
- innovation.

This approach simplified the process of assessing relative performance. Our approach, and the sources of information that we used, are summarised in Table 3.1.

16 For a detailed discussion of the methodology used in 2001, see pages 47 to 104 of the Strategic Review of Charges 2002-06.
17 See Chapter 18 of the Strategic Review of Charges 2002-06.

Table 3.1: Methods for assessing capital efficiency

Area identified for efficiency	Tools
Strategic asset management	Information project, industry consultation, benchmarking
Programme planning or investment appraisal	Information project, industry consultation, benchmarking
Procurement	Cost base analysis
Innovation	Babtie Group report

We were aware that there was a considerable efficiency gap in the delivery of capital investment. On balance, we considered that it would be better to set the target on the same basis that we had used for operating expenditure. The capital target was therefore set at 80% of the gap in efficiency between the industry in Scotland and the Ofwat benchmark (not the leading companies). We also decided to phase the capital efficiency targets.

We applied the capital expenditure efficiency target to 92% of the Quality & Standards II capital programme, as around 8% was accounted for by capitalised operating costs. The operating cost efficiency targets were applied to these capitalised operating costs.

Need for financial sustainability

It is not a straightforward process to compare financing of the water industry in England and Wales with that in Scotland. It is important to bear in mind that the industry south of the border is privately funded. This has the drawback of requiring customers to pay a higher cost of capital, although it does provide a buffer, which insulates customers from any operational or legislative shocks. The important factor for a private company (and from Ofwat's perspective) is therefore whether its financial ratios make it possible to attract capital from the markets. At the Strategic Review of Charges 2002-06 we considered that debt payback ratios were the best way to make comparisons of financing both sides of the border.

It could be argued that a more prudent cover should be assumed in a public sector model since there is no shareholder to help cushion any operational or legislative shocks. Tables 3.2 and 3.3 show that Scottish Water was allowed to borrow to the maximum extent allowed according to these two ratios.

Table 3.2: Debt payback ratios: Ofwat target[18]

	Water and sewerage companies	Large water only companies	Small water only companies
Debt payback period (EBITDA basis)[19]	Max 5 years	Max 5 years	Max 5 years
Debt payback period (EBDA basis)[20]	Max 7 years	Max 7 years	Max 7 years

Table 3.3: Debt payback periods: Revenue caps as in the Strategic Review of Charges 2002-06

	Debt payback period in years			
	2002-03	2003-04	2004-05	2005-06
Strategic Review of Charges:				
EBITDA	5.2	4.9	4.1	4.0
EBDA	7.9	7.2	5.5	5.3
WICS estimates:[21]				
EBITDA	4.8	5.2	4.9	5.2
EBDA	7.0	7.7	6.9	7.5

It is clear that given the relatively slow initial progress in improving operating cost efficiency, Scottish Water's debt payback ratio would not have met the Ofwat standard if revenue caps had been set any lower.

It is also instructive to look at the level of investment delivered and the borrowing incurred. Total direct investment was broadly similar on both sides of the border. From 1996-97 to 2002-03, total capital investment, expressed per customer, was £1,061 in England and Wales, compared with £1,090 (excluding PPP) in Scotland[22]. Indirect investment through PPP delivered approximately £550 million of investment outputs. This is broadly equivalent to a further £260 of investment per customer. This suggests that effective investment over this period has been around 30% higher per customer than it was south of the border.

Borrowing has been used extensively in England and Wales and in Scotland to fund investment. Total reported borrowing for the companies in England and Wales in March 2003 was £20.46 billion[23]. Expressed per customer,

18 Ofwat, 'Final determinations, Future water and sewerage charges 2000-05', page 151, Table 28: Ranges for critical financial indicators.
19 EBITDA is earnings before interest, tax, depreciation and amortisation.
20 EBDA is earnings before depreciation and amortisation.
21 Based on regulatory returns.
22 Water Industry Commissioner for Scotland, 'Investment and Asset Management Report 2000-02', Table 3.2, updated to include 2002-03.
23 Ofwat 'Financial performance and expenditure of the water companies in England and Wales', 2002-03 report, Table 7.

this amounts to around £920. The situation in Scotland is very similar, and expressed on a per customer basis the comparable borrowing figure for Scotland is £940. The £940 should, however, be increased to take account of financing costs included in PPP of approximately £260 per customer.

Improved performance monitoring

In the Strategic Review of Charges 2002-06, we sought ministerial approval for the annual reports on the performance of the industry in Scotland. We now publish three annual reports on:

- costs and performance;
- investment and asset management; and
- customer service.

These reports provide objective analyses of the current performance of the industry in Scotland. In future these reports will also serve as useful evidence of the improvements and better value for money that have been achieved.

Lessons learned from Scottish Water's response to the Strategic Review of Charges 2002-06

The Strategic Review of Charges 2002-06 highlighted a number of challenges:

- the need to improve efficiency;
- the potential threat of competition;
- the need to improve understanding of the condition and performance of assets; and
- the benefits to be gained from greater financial sustainability for the industry.

Scottish Water has responded well to these challenges, and customers will begin to see the benefits of this in the charge limits that we have set for the next regulatory control period 2006-10.

There are, however, three areas where we have sought to learn lessons from Scottish Water's response to the Strategic Review of Charges 2002-06. These are:

- presentation of the efficiency targets and consequently the way in which progress is measured;
- definition of the capital programme; and
- the importance of focusing on core activities.

Presentation of efficiency targets

The efficiency challenge faced by Scottish Water in the 2002-06 regulatory control period consisted of two elements:

- an improvement in base operating costs (the efficiency gap that is quantified in the Strategic Review of Charges 2002-06); and
- an improvement in the level of services that should be provided to customers in order to match the levels of service provided south of the border.

We expected Scottish Water to meet any extra costs incurred in improving the level of service to the England and Wales average by reducing costs further in other areas.

This presentation of the efficiency targets (including a cash and a non-cash element) reduced the transparency of our monitoring. Understandably, Scottish Water sought to emphasise the full extent of the efficiency challenge that it faced, but we had to monitor performance against the targets that were agreed as part of the Strategic Review of Charges 2002-06.

In this draft determination we have changed our presentation of operating cost efficiency targets to improve the transparency of our performance monitoring. Rather than set targets that assumed both a reduction in cost and an improvement in the level of service, we have set targets in terms of total allowable operating expenditure (not including depreciation).

We have set total allowable operating expenditure at a level that we believe is sufficient for Scottish Water to carry out its operations for each year of the regulatory control period. This is the amount that we have allowed to be funded through customer charges. It is made up as follows:

Figure 3.1: Calculation of total allowable operating expenditure

Total allowable operating expenditure
=
Baseline operating expenditure
±
Assessed changes in baseline operating expenditure
-
Efficiencies in baseline operating expenditure
+
New operating expenditure
-
Efficiencies in new operating expenditure
+
PPP operating expenditure
+
New PPP operating expenditure
+
The impact of annual inflation on all of these components

We will no longer refer to a monetary value for the total efficiencies required or to the overall percentage reduction required. However, if stakeholders want to count the total monetary value of the efficiencies required in this regulatory control period, in order to compare it with that used in the Strategic Review of Charges 2002-06, for each year they should add the following then adjust for annual inflation:

- efficiencies in baseline operating expenditure; and
- efficiencies in new operating expenditure.

Definition of the capital programme

The lack of a clearly defined investment programme for Quality and Standards II has had a significant impact on customers. A typical example of this is planned improvements to the waste water system on the island of Arran. The former West of Scotland Water Authority made a number of statements about improvements to the waste water network on Arran. These included the intention to provide 'secondary' (biological) waste water treatment and allow for more properties to be connected to the public sewerage system.

Scottish Water has subsequently concluded that the required environmental standards can be met more effectively and efficiently through primary treatment, with longer sea outfalls. A number of residents in Arran are dissatisfied with the revised scheme, which they believe has limited the potential for development. In the absence of a defined investment programme, it has not been possible to determine whether the original waste water scheme for Arran that was contained in Quality and Standards II included funding for growth.

Our experience in seeking to define the capital programme after the Strategic Review of Charges 2002-06 has taught us the importance of having a fully defined capital investment programme. Our discussions with SEPA and the DWQR also lead us to conclude that the outputs to be delivered by each project must be clearly defined and quantified.

As a result we have taken a number of steps to ensure that the capital programme for 2006-10 will be better defined and that the customer will benefit fully from the improvements required by the Ministerial Guidance.

We are publishing the proposed investment programme alongside this Strategic Review of Charges 2006-10. Customers should therefore be able to track delivery of the improvements for which they are paying. This would help ensure transparency and accountability in the delivery of agreed benefits to customers and to the environment.

In addition, we are introducing a detailed substitution process by which Scottish Water will have to account in advance for any changes to the baseline investment programme. We have seen how, in Quality and Standards II, changing priorities, revised policies and practices, new technologies and new information may mean that outputs need to be amended.

Importance of focusing on core activities

In the Strategic Review of Charges 2002-06 we reviewed the experience of the privatised water and sewerage companies in England and Wales in generating additional sources of business from non-core activities.

We also looked at the development of non-core activities in Scotland and their success or otherwise. We concluded that investment in new business by Scottish Water would need to be approached very cautiously.

The financing for any new ventures in Scotland – whether a small opportunity for a start-up with potential for organic growth, or an acquisition – must ultimately be obtained from customers of the core business or from taxpayers. We took the view that commercial opportunities should be carefully assessed, because even if the venture appeared to generate a return relatively quickly, there may be hidden costs (such as costs to exit the business), which could have an adverse impact on customers' bills in the future. There was also a risk that senior management would spend an undue amount of time on activities relating to the new venture.

Stakeholder criticisms of the Strategic Review of Charges 2002-06

Some stakeholders criticised the findings and recommendations of the review.

Areas of criticism included the following:

- the process of harmonising charges;
- the increase in fixed charges;
- that the industry should have been allowed to borrow more;
- that the efficiency targets were unreasonable;
- that there had been a lack of clarity in roles and responsibilities; and
- that we had not explained our logic, assumptions and answers sufficiently well.

We address each of these criticisms in turn. For each, we summarise the criticism and provide a response. In preparing the Strategic Review of Charges 2006-10, we have learned from stakeholders' views about the 2002-06 Review. We have set out to address their concerns where possible.

The process of harmonising charges

Issues raised by stakeholders

There are three main criticisms that have been made about the harmonisation of charges. These are that there was insufficient communication, there should not have been harmonisation for non-household customers and that the process was completed too quickly.

Our response

In the Strategic Review of Charges, we highlighted the impact that harmonisation would have on different types of businesses. However, we accept that many of those that were adversely affected by harmonisation feel that there was insufficient communication with them about the issue. We believe that Scottish Water, the Scottish Executive and this Office can learn from this perceived lack of communication.

We have reviewed the argument that harmonisation for non-household customers should not have taken place. Our view is that there are two key alternatives: the first is to harmonise charges for all non-household customers; the second is to opt for fully cost-reflective tariffs for all non-household customers.

The first approach of harmonised charges is consistent with pricing in other utility and public good services (for example, Royal Mail). When charges are harmonised, there is no risk of a 'post code' lottery, ie where the price of the water and sewerage service varies according to where the customer is located.

The second approach of fully cost-reflective charges could make the service prohibitively expensive for those who are located in remote areas. This could also have an adverse impact on smaller businesses located in more urban areas. Additionally, if a larger customer were to opt for an 'off-network' solution, this could have a dramatic impact on the bills of those customers located in the same water supply zone. We remain convinced therefore that harmonisation for all customers is in the long-term interests of all customers.

We have also reviewed the argument that harmonisation was introduced too quickly. Our analysis suggested that the impact would be less, and would affect fewer customers, if harmonisation were implemented swiftly. This was because the tariff regimes were so different for each of the three authorities. We also considered that it would have been difficult to justify much higher prices to some customers when an identical customer in a different part of Scotland was paying much less. Indeed, there was evidence that this was becoming an issue for some customers (for example, large water users in the north of Scotland) before the decision to merge the three former water authorities.

The increase in fixed charges

Issues raised by stakeholders

In the Strategic Review of Charges 2002-06, we argued that cost-reflective prices would play an important role in ensuring that larger water users chose to maintain their connection to the public system. Some stakeholders have objected to this. One of the objections is that the fixed charges were introduced too quickly and were not sufficiently well communicated. There were other objections from both metered and unmetered customers.

Standing charges were increased for metered customers. Metered customers with relatively low usage will suggest that they should pay for what they use. They assert that this is what happens in other utility services.

Our response

We would again accept that many customers felt that there had been insufficient communication of the impact of increasing fixed charges. There are lessons that we can learn from this.

We have looked again at the issues raised by metered customers. Our view remains that the cost of supply is a function of peak consumption, rather than simply the total consumption. It seems to us that it is appropriate that all connected customers should make a contribution to the maintenance of the water supply and sewerage infrastructure. The increase in fixed charges is consistent with this. To delay the implementation of fixed charges would have been to accept that larger users should continue to make a greater contribution to the costs of maintaining the network.

A minimum charge was introduced for unmetered customers. The unmetered customer had always paid a fixed sum for the water and sewerage service. The amount depended on the rateable value of the property served. The unmetered customer was therefore objecting to the level of the bill, rather than the fact that the bill did not vary with volume.

Our view is that there is little merit in charging for water and sewerage services by rateable value. This means that a small city centre shop might pay more than a much larger shop in a rural area (even though the latter is probably much more expensive to supply). We believe that the minimum charges proposed by Scottish Water and agreed by us were not unreasonable. As an example, many rateable value customers paid less than Band A households.

The industry should have been allowed to borrow more

Issues raised by stakeholders

Some stakeholders have argued that if the industry had been allowed to borrow more, charges could have been kept at a lower level.

Our response

It is true that borrowing more during the 2002-06 regulatory period could have reduced bills for customers – but only at the expense of higher bills in the future. In effect, customers would have swapped an environmental and public health compliance backlog for an increased debt. We discussed issues relating to our approach to debt in our methodology consultation[24]. We did not receive any substantive objections to our proposed approach. We can see no merit in increasing debt faster than the economic value of net new assets. This would only make the industry less able to respond to shocks.

The efficiency targets were unreasonable

Issues raised by stakeholders

Scottish Water's trade unions have consistently argued that both our approach to setting efficiency targets and our assessed scope for efficiency were unreasonable. They argue that comparing the Scottish water industry's performance with that of the companies in England and Wales does not take account of:

- the industry south of the border being in the private sector;
- the different geographies and customer bases; and
- the higher level of investment that has been made south of the border.

Our response

Our efficiency assessments take full account of differences in assets, customer bases and geography. The Costs and Performance Reports and the Strategic Review of Charges describe these assessments. We can see no reason why customers should be asked to pay more because the industry remains in the public sector in Scotland. Indeed, given that the public sector benefits from a lower cost of capital, it is reasonable to argue that bills should be lower on a like-for-like basis in Scotland.

A lack of clarity in roles and responsibilities

Issues raised by stakeholders

Some stakeholders expressed their frustration that no-one seemed to want to take responsibility for decisions, nor was it clear who was taking which decisions.

Our response

We agree that there was a perceived lack of clarity about roles and responsibilities. This was due to the nature of the regulatory regime that was in place at that time. This Office has a statutory duty to advise Ministers on the matters to be taken into account, and those to be left out of account, in setting charges for customers. Ministers could accept this advice, amend it (and give reasons) or substitute their own advice (and give reasons). Ministers will commission such advice relatively rarely.

Under the outgoing regulatory framework, each year we have been required to agree the detailed tariffs that Scottish Water proposes to charge. In proposing these tariffs, Scottish Water had to take due account of the advice that has been accepted by Ministers. We had to accept these tariffs if we believed that they were fully consistent with the advice accepted by Ministers. Ministers had no role in setting annual tariffs unless Scottish Water and this Office did not agree. While the legislative position was clear, we accepted that it could be difficult to understand that this Office had little decision-making discretion, that Scottish Water is bound to take account of our advice, and yet Ministers could not easily intervene unless they commissioned new advice. Under the new regulatory framework, which this draft determination contemplates, this Office will acquire a new determinative role. We are confident that this change will improve clarity as to roles and responsibilities.

A lack of explanation

Issues raised by stakeholders

Some stakeholders have commented that they found the explanations and reasoning put forward in the Strategic Review of Charges 2002-06 to be incomplete or confusing.

Our response

We tried to document our assumptions, logic and answers as completely as possible in the Strategic Review of Charges 2002-06. Given the amount of information that we use and the complexity of the analysis it can

[24] See Chapter 7, Volume 2 of our methodology, 'Our work in regulating the Scottish water industry: Background to and framework for the Strategic Review of Charges 2006-10'.

sometimes be difficult to explain each issue as fully as we might like. We had to strike a balance between the detail and length of the Strategic Review 2002-06 and the completeness of our presentation of our assumptions, logic and answers. We have provided much fuller explanations at this Review.

Changes to the legislative framework

There have been a number of changes to the legislative framework since the last Strategic Review. These changes are discussed below.

In 2002 the Water Industry (Scotland) Act, which had the principal function of establishing Scottish Water, also limited the function of this Office to the promotion of the interest of customers of the core business. In 2005, the Water Services etc. (Scotland) Act further strengthened the regulatory framework.

Water Services etc. (Scotland) Act 2005

The original purpose of the Water Services etc. (Scotland) Act 2005 was to introduce a framework for retail competition and to safeguard public health through introducing a ban on common carriage. It also sought to introduce regulation of trade effluent charges.

The original intention was that the Act should require the Water Industry Commissioner to introduce and administer a regime to license retail competition for ‘non-household’ (business and commercial) customers. The introduction of this framework has had a direct impact on this Strategic Review of Charges.

This framework is different to that which was introduced south of the border by the Water Industry Act 2003. The principal differences are that common carriage will not be allowed in Scotland, but that all non-household customers will be able to choose their supplier. Scottish Water will be required to establish an ‘arm’s length’ subsidiary company to provide retail services to non-household customers. This is consistent with the recommendations on accounting and legal separation that we included in the Strategic Review of Charges 2002-06.

Proposals to strengthen the regulatory regime

The Water Services etc. (Scotland) Act 2005 has made a number of important changes to the regulatory framework. Its objective is to strengthen the regulatory framework for the water industry, and to ensure that there is a robust and transparent regime that operates in the interests of all customers. The Act includes measures to improve the accountability and transparency of economic regulation, including replacing the current individual Water Industry Commissioner with a body corporate, the Water Industry Commission for Scotland. The Act then goes on to give the Commission powers of determination over Scottish Water’s charges.

In 2004 the financing of the water industry in Scotland came under scrutiny by the Finance Committee of the Scottish Parliament.

Part of the remit of the Committee was to investigate accountability within the water industry in Scotland. The Committee considered the role of the Water Industry Commissioner, and relationships with Scottish Water, the Scottish Executive and local authorities.

The Finance Committee published its findings in April 2004. The report included a recommendation to strengthen the regulatory regime:

> “The Committee believes that an improved structure and support for the WIC is needed to ensure independent regulation and transparency across the industry. Modelled on some of the English and UK regulators, an Office of the Water Industry Commissioner, including a non-executive membership, could provide greater accountability and continuity for the Scottish water industry. Consideration should be given to whether certain decisions should be taken by the WIC in the context of advice from Ministers rather than the reverse.”

The Scottish Executive agreed and included proposals in what is now the Water Services etc. (Scotland) Act 2005.

The changes to the regulatory regime are examined later in Chapter 4. Before reviewing these proposals, it is helpful to examine the components of UK regulatory policy that the Scottish Executive is proposing to introduce to the water industry in Scotland.

Regulatory functions

Broadly, a key function of regulators is to determine the charges levied by regulated companies. At a more detailed level, their functions are more far-reaching than simply the setting of charges. Typically, regulators' functions would also include the following:

- imposing conditions of appointment on industry participants;
- resolving disputes between industry participants and customers;
- determining the basis and extent of charges; and
- dealing with the insolvency or failure of an industry participant.

These are wide-ranging functions, which will impact directly on industry participants and customers. To ensure that these functions are exercised properly, regulated companies have a right of challenge. There are two possible avenues for challenge – the Competition Commission and judicial review.

Appeal to the Competition Commission

If a regulated company disputes the regulator's charge limits, it can require the regulator to refer the determination to the Competition Commission.

The Competition Commission is an independent public body with the technical, economic and legal expertise to adjudicate in disputes between companies and their regulators. Its involvement helps to ensure that the charge-setting process, carried out in the knowledge of a possible referral, is robust and transparent. If a case is referred to it, its decision will be binding. This check also ensures that regulators' decisions are subject to appropriate expert scrutiny.

Following a referral, the Competition Commission would initiate a process of determining the charge limits. Its functions are set by statute. Neither the regulator nor the water company requesting referral can narrow down or broaden out the Commission's functions. The matters that the Commission must take into account are the same as those taken into account by the regulator.

The Competition Commission's conclusions are binding, subject to judicial review by the Courts. Until the Commission makes its decision, the regulator's original determination stands. In practice, this means that all companies must implement the charge limits set in the regulator's determination until such time as the Competition Commission has reached a conclusion.

Once the Competition Commission has completed its inquiry and made its determination, the charge limits set by the regulator are replaced. The new limits would apply for the remaining years of the determination period.

Judicial review

In the UK, public bodies are generally subject to judicial review. In general terms, the purpose of judicial review is to protect citizens from abuse by ensuring that the powers and duties of government and other public bodies are exercised properly and lawfully.

Judicial review is the mechanism used by the Courts to review the way in which government Ministers or departments, local authorities and/or other public bodies exercise their powers and carry out their duties. It is concerned with the legality of the action or decision and the decision-making process rather than the actual merits of the decision itself.

Judicial review may be sought by a company, an individual or even a representative group that has a sufficient interest in the challenged decision, provided there is no other suitable means of redress available. In the present case, the possibility of appeal to the Competition Commission is likely, in relation to many points, to provide such a suitable alternative and to preclude the opportunity for seeking judicial review of the decision of the Commission.

Conclusion

We have examined the changes to the regulatory framework that have taken place since we completed the Strategic Review of Charges 2002-06. These changes have been introduced in the Water Industry (Scotland) Act 2002 and the Water Services etc. (Scotland) Act 2005. In general these changes have strengthened the role of regulation and should lead to improved transparency and accountability. In Chapter 4 we discuss the provisions of the Water Services etc. (Scotland) Act 2005 in more detail.

Chapter 4
Implementing the provisions of the Water Services etc. (Scotland) Act 2005

Introduction

In this chapter we examine the provisions of the Water Services etc. (Scotland) Act 2005 in more detail. In particular, we consider the impact that the creation of a Water Industry Commission with powers to determine charge caps has had on the Strategic Review of Charges 2006-10.

The Act strengthens regulation of the Scottish water industry and brings it into line with the regulation of utility and infrastructure businesses across the UK. This strengthened regulation should ensure that customers of the water industry in Scotland will continue to see an improvement in the value for money they receive.

The introduction of a competition framework will also bring benefits to customers, although it is likely that the benefits of this framework will only begin to be seen towards the end of the 2006-10 regulatory control period.

This chapter first considers the provisions of the Water Services etc. (Scotland) Act 2005. It then examines the appointment of the Commission, provides a timeline for the remainder of the Strategic Review of Charges 2006-10, and discusses the implications of the changes that result from the Act.

Functions of the Act

The Act has two main functions.

- It creates a Water Industry Commission to replace the current Water Industry Commissioner. The Commission will have the power to determine the maximum level of charges required to ensure that the objectives of the Scottish Ministers can be met at lowest reasonable overall cost. This contrasts with the current duty of the Water Industry Commissioner to provide advice on the level of charges required.

- It introduces a framework for competition in the water industry that is consistent with the social, environmental and public health objectives of the Scottish Ministers.

The Water Industry Commission for Scotland

The Commission will comprise a non-executive Chairman and four other non-executive members. The Chief Executive will also be a member of the Commission.

Other regulators have either already adopted Board structures or are moving towards them. Where they have been set up, Boards not only depersonalise regulation (through collective responsibility) but also bring relevant professional experience to bear on the work of the regulator (through non-executive directors with relevant professional expertise).

For example, the Gas and Electricity Markets Authority determines strategy and makes major policy decisions for Ofgem to implement. It comprises a Board of five executive and nine non-executive members, appointed by the Secretary of State for Trade and Industry. The non-executive directors have backgrounds in the commercial, financial, public sector and energy industry sectors.

In the water sector in England and Wales, the Water Act 2003 made provision for the Water Services Regulation Authority to be set up. This Board will replace the Director General of Water Services. However, the decision was taken not to establish the authority until after Ofwat had completed its 2004 price review.

In the communications sector, Ofcom's Board provides strategic direction for Ofcom. It comprises three executive and six non-executive directors. The non-executive directors have backgrounds in telecommunications, news media, journalism, property and economics.

The Office of Rail Regulation is led by a Board appointed by the Secretary of State for Transport. It has five executive and six non-executive directors. The non-executive directors have backgrounds in law, regulation, finance, customer service and railways. It replaced the Office of the Rail Regulator.

Determination of charge caps

This Strategic Review of Charges is being undertaken at a time of legal transition. It was, like the previous Review, commissioned by Ministers under the Water Industry (Scotland) Act 2002. However, unlike that Review, it is expected to result not in advice to Ministers on charges but rather in a charge determination made under the Water Services etc. (Scotland) Act 2005. In this section, we set out a description of the transitional regulatory framework under which we have undertaken the current review.

Water Industry (Scotland) Act 2002

Under section 33 of the 2002 Act, the Water Industry Commissioner must, when required by Ministers, advise them on the matters to be taken into, or left out of, account by Scottish Water in fixing charges in charging schemes. In preparing this advice (which is to apply in relation to charges schemes made during such period as Ministers may specify) the Commissioner is to have regard (in addition to guidance and directions from the Scottish Ministers) to such matters as (a) the economy, efficiency and effectiveness with which Scottish Water is using its resources in exercising its core functions, (b) the likely cost to Scottish Water, for the period of the advice, of exercising such functions at the standard or level specified by Ministers and (c) the likely resources, other than income from charges for goods and services, available to Scottish Water for the period of the advice.

Ministers must, within three months of receiving this advice from the Commissioner, either accept the advice, with or without modifications, or reject the advice and substitute their own advice for it. The Commissioner must publish the advice as accepted, modified or substituted, together with any reasons given by Ministers for any modification or rejection.

Currently, when Scottish Water makes a charges scheme and when the Commissioner and Ministers consider whether to approve such a scheme, each must, under section 31 of the 2002 Act, have regard to any advice published under section 33 in force at the time of the making of the scheme.

Water Services etc. (Scotland) Act 2005

Section 21 of the 2005 Act (which has not yet been commenced) repeals sections 31 and 33 of the 2002 Act. It also inserts a number of new provisions into the 2002 Act which, when commenced, will establish a new legal framework under which Scottish Water levies charges on its customers. These are considered below.

Under section 29A of the 2002 Act, Scottish Water must in future make a charges scheme by reference to a determination made under section 29B by the new Water Industry Commission established under the 2005 Act. In particular, Scottish Water's schemes may not fix charges in excess of any maximum set by virtue of the determination.

Section 29B of the 2002 Act requires the Commission (see above) to determine maximum amounts of charges by reference to which a charges scheme is to be made and provides that these maximum amounts apply in relation to such period as the Scottish Ministers may specify. The Commission is to publish a draft determination on which it must consult prior to taking its final decision.

The Commission must pursuant to section 29C:

a) exercise its functions to make such determinations for the purpose of ensuring that (so far as is consistent with compliance with point (b) below) charges schemes give effect to any statement of policy regarding changes made by Ministers under section 29D;

b) exercise those functions for the purpose of ensuring that (so far as is consistent with Scottish Water complying with its statutory obligation to secure that its annual income is not less than its annual expenditure). Scottish Water's receipts from (i) its income from charges for services provided in the exercise of its core functions and (ii) any grants made, sums borrowed or any other resources reasonably available to it for the purposes of the exercise of those functions, are not less than sufficient to meet the expenditure required for the effective exercise of those functions; and

c) in exercising those functions, have regard to any guidance issued to Scottish Water by Ministers and any directions given to Scottish Water under section 44 or 56 of the 2002 Act, so far as relevant in relation to charges schemes.

Section 29G of the 2002 Act provides that, in relation to point b) above, Scottish Water is to be taken to be exercising its core functions effectively if (in discharging its statutory duties and contractual obligations relating to the exercise of those functions) it makes such use of its resources that, year on year, it achieves at the lowest reasonable overall cost the objectives contained in any directions given by reference to new section 56A of the 2002 Act.

The Commission may also review the maximum charges set under a determination by virtue of section 29F of the 2002 Act where, since the determination was made, there has been or is likely to be a material change in the income available to Scottish Water or expenditure required for the effective exercise of its core functions. A review of this sort might result in the revision of the maximum charge level set in the determination.

An important component of the new framework is that Scottish Water will have the right (to be introduced by a statutory instrument made under the Scotland Act 1998) to require the new Commission to make a reference to the Competition Commission in respect of its determination.

Once the Commission has set maximum limits for Scottish Water's charges, Scottish Water will be required to propose a detailed charges scheme. The scheme must adhere to the maximum charges set out in the Commission's determination. It is expected that Scottish Water will be asked to propose charges schemes on an annual basis.

An important feature of the proposals in the Act is that Scottish Water will no longer have a general discretion to make agreements with individual customers about their charges. Instead, all charges must be made by reference to a charges scheme, save for any departures from the charges schemes which will have to be specifically authorised by the Commission on the basis that the charge-payer has taken actions that reduce the cost to Scottish Water of providing services to them and the departure is otherwise justified in the circumstances of the case. The Act does not allow for existing agreements to be renewed or extended, but it does contain a specific provision that existing agreements may continue until they expire.

Principles of charging for water services

In February 2005, Ministers published a proposed 29D statement which they intended formally to make following enactment of the 2005 Act. Certain elements of this statement are set out below (a fuller description is contained at Chapter 14 of Volume 4).

Minister's proposals were informed by an extensive consultation exercise, which the Scottish Executive undertook during the summer of 2004. 'Paying for Water Services 2006-10' set out the Scottish Executive's views on the principles that should underpin charging and the application of those principles. It also invited responses on the proposals. Views expressed by customers and other interested parties were taken into account in the proposed section 29D statement.

The proposed section 29D statement sets out two objectives, namely, that Scottish Water should achieve the maximum affordable improvements in public health and environmental protection, and support housing in communities across Scotland through investment in new water and sewerage capacity. The new Commission should determine charge limits that will enable Scottish Water to achieve its objectives and improvements in its operating performance on the basis of charges that are affordable and stable across the review period and sustainable in the long term. In particular, Ministers have indicated that an objective for the Commission is to keep average charge constant in real terms during the Review period. However, stable charges ar not to be secured at the expense of Scottish Water's longer-term financial stability: Scottish Water's financial strength should be maintained over the period 2006-10, or if possible improved slowly over that time.

The proposed statement also provides that the maximum sum that Ministers have set aside for lending to Scottish Water in each of the years 2006-10 is £182 million, pending the charge determination and the new Commission's decision on the sustinable level of borrowing required to underpin the determination and Scottish Water's investment programme. In addition, it states that public expenditure support to Scottish Water 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.

Introduction of a framework for competition

The Water Services etc. (Scotland) Act 2005 includes provisions requiring the Water Industry Commission to introduce and administer a regime to license retail competition for 'non-household' (business and commercial) customers. We propose that the licensing regime should be in place in Scotland by April 2008.

The key provisions in the Act are as follows:

- Prohibitions on common carriage[25] and on the provision of water and sewerage services to households by anyone other than Scottish Water.
- A power for Ministers to require Scottish Water to establish a separate retail business – effectively establishing Scottish Water's retail business as a 'provider' that will be subject to the same licensing regime as all other 'providers' of water and sewerage services.
- A regime, to be introduced and administered by the Water Industry Commission, which will license 'providers' of retail water and sewerage services to non-household (ie business or commercial) customers. This provision effectively permits competition in the retail of water and sewerage services.

These provisions are examined in greater detail below.

Prohibiting common carriage on public networks

The Scottish Executive decided that common carriage on public networks should be prohibited. It believed that if third parties had access to the networks this would pose risks to public health and the environment. It believed this would compromise Scottish Water's ability to manage the network safely. In its view, the consequences of common carriage could include contamination of the public water supply, interruptions to the water supply and damage to the public infrastructure resulting in a threat to public health. Similarly, on the waste water side, they considered that there could be pollution, including sewage flooding, interruption to the supply and again damage to the public infrastructure – threatening public health and the environment.

The Executive concluded that the risks to public health and the environment would outweigh any foreseeable benefits that might arise from competition in treatment services. The Water Services etc. (Scotland) Act 2005 therefore includes the provision that no-one other than Scottish Water can use the public networks to carry out the physical supply of water or sewerage services.

Establishing retail competition to non-household customers

The Act contains provisions which allow for retail competition to non-household customers. Although Scottish Water retains sole responsibility for treatment and distribution on the public networks, it will be able to treat water or waste water for a third party 'retailer'. The Act changes Scottish Water's role from its present role of supplier in that while it will continue physically to supply water and sewerage services, it will do so on behalf of the retailer. It will be the retailer, rather than Scottish Water, who will have the direct commercial relationship with the customer.

The Act restricts retail competition to non-household customers only. This reflects the Scottish Executive's view that retail competition poses risks for households. The Executive is concerned about the impact that introducing retail competition for households could have on the link between charges and the Council Tax band of the property served (and as a result the discounts applied, for example to single adult households). The Scottish Executive regards the link between Council Tax bands and water charges to be an important element in its social inclusion policy. In the view of the Scottish Executive, this link should mean that charges broadly reflect ability to pay.

[25] 'Common carriage' — where Scottish Water would use its system of water mains to carry water treated by a competitor to the competitor's customers, or where it would use its sewers to carry waste water from a competitor's customers to the competitor's treatment works.

The approach taken in the Act differs from that which has been introduced south of the border. In England and Wales, the Government decided to phase the introduction of competition through the use of thresholds. At present, only premises using more than 50 megalitres of water a year are eligible for competition. These thresholds are important because they seek to ease the transition to common carriage. Common carriage raises practical issues for the incumbent water provider relating to how to manage the impact of new entrants gaining access to its infrastructure. Common carriage can also lead to the problem of 'stranded assets', that is treatment works which the incumbent no longer requires.

Establishing a licensing regime

The Act introduces a licensing regime, the purpose of which is to ensure that all customers served by the public networks are treated in an equal way. It is important that, with the introduction of competition, retailers pay a fair wholesale price that disadvantages neither businesses nor household customers. The licensing regime will be established and operated by the new Commission.

The Act introduces two types of licence:

- A water services retail licence – the purpose of which is to establish a legal right for the holder of such a licence to enter into contractual agreements for the provision of water services with non-household customers on the public networks.

- A sewerage services retail licence – the purpose of which is to establish a legal right for the holder of such a licence to enter into contractual agreements for the provision of sewerage services with non-household customers on the public networks. This licence will cover trade effluent services, although it will not affect Scottish Water's responsibility for monitoring compliance with trade effluent consents and agreements.

The Act places a duty on the Commission to monitor compliance with the terms and conditions of licences and to take any action necessary to ensure compliance. Licence conditions will ensure that retailers meet their obligations to contribute towards the costs of maintaining the public networks. In granting licences, the Commission will be required to satisfy itself that the applicant has the financial strength and the operational and managerial capacity to meet their licence conditions as a retail supplier.

The Commission will administer the licensing regime on the basis of regulations made by Ministers. The regulations will be the subject of consultation before being given effect in secondary legislation. Their purpose will be to ensure that there is a transparent, fair and proportionate process by which the Commission considers licence applications, grants licences and subsequently monitors compliance with licence conditions.

The Act also confers a duty on the Commission to exercise its licensing functions in such a way as to ensure that the interests of all customers served by the public networks continue to be safeguarded. In particular, it provides a duty on the Commission to ensure that the new regime operates in a way that is not to the detriment of water customers as a whole.

The Act also requires the Commission to exercise its licensing functions to secure the participation of retailers in an orderly manner. The Commission will be able to direct Scottish Water or retailers (actual or prospective) to provide or exchange information.

The Act gives Scottish Ministers the power to direct Scottish Water to establish a subsidiary, with a view to ensuring the separation of its statutory and licensed activities. The Scottish Water retail business will be in direct competition with other retailers, and must not use or be thought to be using its position as sole provider of wholesale services to put its competitors at a disadvantage. The retail arm will be subject to the same regulation as other retailers.

Timeline for the introduction of new tariffs

The final determination of prices will be issued at the end of November 2005 by the Water Industry Commission. It is likely to include a series of charge caps for each of the tariff baskets that we have identified in Volumes 3 and 7 of this draft determination. Scottish Water will then propose a series of tariffs that are consistent with these general charge caps. The new tariffs will take effect from April 2006.

Table 4.1: Timeline for the introduction of new tariffs

July 2005	The Water Industry Commission assumes responsibilities for the Office of the Water Industry Commissioner for Scotland.
July–September 2005	Stakeholders have the opportunity to make representations on the draft Strategic Review of Charges 2006-10 in the period between 1 July 2005 and 23 September 2005. Representations should highlight issues that stakeholders believe have not been taken sufficiently into consideration. Stakeholders should highlight the consequences and impact of their representations both on those who would benefit and those who would lose out.
23 September–30 November 2005	The Water Industry Commission considers representations on the draft determination. In the light of representations from stakeholders, the Commission produces and consults on its own draft determination. The Scottish Executive may also decide whether to amend its objectives for Scottish Water during the regulatory control period.
30 November 2005	The Water Industry Commission makes and publishes its final determination. The charge limits set in the final determination will apply to the scheme of charges that is to come into effect on 1 April 2006.
December 2005	Scottish Water submits to the new Water Industry Commission for approval its scheme of charges for 2006-07. The Commission will approve the scheme of charges if it determines that Scottish Water's proposals are consistent with the final determination, published in November 2005.
February 2006	This is the deadline for Scottish Water to appeal to the Competition Commission. In the event that Scottish Water decides to appeal to the Competition Commission against the limits, the limits will continue in effect until the Competition Commission comes to a decision on the appeal.
April 2006	New tariffs come into force.

Implications of establishing the new Water Industry Commission for Scotland

Scottish Ministers will set the public policy framework and act as owners of Scottish Water. Responsibility for decisions on setting charge limits will pass to the new Commission.

We welcome provisions in the Act that give the Commission the power to decide charge limits within a policy framework set by Ministers. This will ensure that authority and responsibility are aligned. The responsibility for each decision will be clear and unambiguous. This should be easier to understand than the previous system where Ministers had to take decisions on the basis of the Commissioner's advice.

The Commission will operate within a ministerial policy framework. Scottish Water's right of appeal against the Commission's decisions to the UK Competition Commission is an important safeguard.

We believe that the Act strengthens the regulatory framework in Scotland and will help improve both actual and perceived accountability. The establishment of a Commission should depersonalise regulation – a Commission arriving at a joint decision is likely to be considered more accountable than an individual with a similar responsibility.

Implications of the framework for competition

One of the key challenges for the Strategic Review of Charges 2006-10 has been to set reasonable wholesale and retail charge caps. There has been no precedent in the water industry for the assessment of a charge cap for the wholesale service. This review has set retail charge caps for household customers and an overall level of wholesale charge caps for the 'non-household' customers. In effect this has required us to decide the appropriate cost and profit of a retailer (ie the difference between retail and the overall level of wholesale charges).

When retail competition was introduced into the energy market, regulators continued to set a limit for retail charges for a period after the introduction of competition. We believe that regulation of retail charges until competition is properly established will be important as it will help to ensure that there is an orderly, sustainable market.

The overall level of wholesale charges is critical. If it is too high, new entrants will not be able to cover their costs and consequently will not enter the market. If it is too low, the core business of Scottish Water would suffer and retailers could make excessive profits.

We have sought to involve stakeholders so that all interested parties can understand how we set the overall level of wholesale charges. We did this by outlining a very detailed work plan for the Strategic Review of Charges 2006-10[26]. We also arranged a number of stakeholder information days.

We considered that this consultation was important for the following reasons.

[26] 'Our work in regulating the Scottish water industry: setting out a clear framework for the Strategic Review of Charges 2006-10', July 2004.

- New entrants are likely to want reassurance that Scottish Water is not able to subsidise or offer favourable terms to its new retail entity in order to retain customers. Without this reassurance, new retailers would be discouraged from entering the market or could challenge the incumbent under competition law.

- If the overall level of wholesale charge has not been properly set, there will be an unintended cross-subsidy either to or from non-household customers in the new competitive market – at the expense, or to the benefit, of Scottish Water's household customers.

The commissioning letter for the Strategic Review of Charges 2006-10[27] required us to set 'charges limits' rather than 'revenue caps'.

A revenue cap allows the balance of revenue between customer groups to be altered; it also allows for tariffs to be increased to reflect the loss of part or all of a customer's business. It is in the general customer interest that Scottish Water should seek to reduce costs to counter any fall in revenue. However, under a revenue cap Scottish Water could seek to increase tariffs to captive customers to maintain its revenue.

A charge cap can prevent such rebalancing. It limits the increase in a particular tariff rather than the increase in revenue (all of the charges multiplied by all of the services provided). Setting charge caps has, however, required us to collect more information.

Conclusion

The Water Services etc. (Scotland) Act 2005 has strengthened the regulatory framework in Scotland. Customers of the Scottish water industry can therefore look forward to further improvements in value for money.

The revised regulatory framework also clarifies roles and responsibilities, and as a result should reduce uncertainties for customers and other stakeholders.

[27] Letter from the Minister for Environment and Rural Development Ross Finnie MSP, dated 26 May 2004 to Alan Sutherland, Water Industry Commissioner for Scotland.

Chapter 5
Other inputs to the Strategic Review of Charges 2006-10

Introduction

In the previous chapter we discussed the impact on the Strategic Review of Charges 2006-10 of the regulatory changes that were introduced in the Water Services etc. (Scotland) Act 2005. This chapter outlines the other major factors that have influenced this draft determination. Some of these factors were introduced in the Minister's February statement of the objectives for the water industry. We have also taken full account of other inputs including regulatory returns and letters, Scottish Water's business plans and the recommendations of the Finance Committee.

Scottish Executive consultations and inputs

The ministerial statement of the objectives for the water industry in Scotland was an important input to this Review. It provided information about the investment priorities that must be delivered and the principles of charging that should underpin the draft determination. The statement also set the borrowing limits that apply (or are likely to apply) during the four-year regulatory control period. The ministerial statement was informed by the Quality and Standards process and the Principles of Charging consultation. This statement is discussed in detail in Chapter 16 of Volume 4. We discussed the two Scottish Executive consultations in our methodology publications[28].

Quality and Standards process

Quality and Standards III provided advice to Scottish Ministers about the investment priorities for the period 2006 to 2014. This Strategic Review of Charges 2006-10 covers only the first half of that period.

At the start of the Quality and Standards III process, the Scottish Executive established a project board comprising a number of stakeholders. The board has had overall responsibility for developing the options to be included in the Quality and Standards III consultation.

Detailed definition of the required investment was delegated to a number of specialist groups, each of which was responsible for a work package. These work packages included:

- maintenance;
- growth in the water and sewerage networks;
- environmental improvements;
- drinking water quality; and
- other important issues for customers.

Each work package identified investment 'drivers'. The performance of Scottish Water's assets relative to the identified investment drivers at the end of the Quality and Standards II investment programme was assessed.

Scottish Water was then asked to cost the gap between the expected position at the end of Quality and Standards II and each of the identified scenarios. The specialist groups responsible for work packages each submitted an interim report to the project board in April and May of 2004. These interim reports were used by the Scottish Executive to inform the Quality and Standards III consultation.

Ministers' decisions were supported by a wide-ranging public consultation about Quality and Standards III ('Investing in Water Services 2006-10 – The Quality and Standards III project: A consultation paper', published in July 2004). Their decisions were also informed by independent research[29].

Quality and Standards III has noted that substantial investment in water quality and environmental performance is likely to continue for the foreseeable future. In its Quality and Standards III consultation, the Scottish Executive states[30]:

"What is certain, is that substantial expenditure on the improvement of the water environment will be required for very many years to come, for Quality and Standards III and beyond."

28 Volume 3, Chapter 2 – 'Paying for water services 2006-10' and Volume 5, Chapter 2 – 'Investing in water services 2006-14'.
29 This market research, conducted by MORI and broadly similar to research conducted in England and Wales, was published in February 2005 with the Ministerial Guidance on the investment programme. Available at www.scotland.gov.uk
30 Scottish Executive, 'Investing in water services 2006-14', page 31.

Principles of Charging consultation

The Minister's statement of the objectives for the water industry and the borrowing limits that have been set was also informed by the Principles of Charging consultation. When the consultation was announced, the Deputy Minister for Environment and Rural Affairs stated that:

"We anticipate this [Principles of Charging consultation] will cover the full range of concerns raised, including the total size of bills, the appropriate mix of fixed and volumetric charges for all types of customer, whether alternatives to the use of rateable values can be used in the calculation of charges, the extent to which metering should be encouraged, what kinds of discount and cross-subsidy are appropriate, what sustainable use of water should mean in practice and how all of these compare with England and Wales."

We believe that it is important that customers understand, in a transparent manner, the likely charges they will pay over the 2006-10 period. These charges will be affected by both the total revenue requirement and by the way charges are allocated between customer groups. Ministers have set these overall charging policy objectives; we explain how these will impact on customers.

Ministerial Guidance

Scottish Ministers have so far provided:

- initial high-level guidance in May 2004 in the commissioning letter for the Strategic Review of Charges 2006-10; and
- detailed guidance in the Ministerial statement made in February 2005.

Ministers may provide final guidance at the end of August 2005, after the draft determination of charges is published.

The initial high-level guidance outlined the factors for us to take into account in preparing this draft determination. It covered the broad arrangements that the Scottish Executive wanted the Strategic Review to follow and provided the Scottish Executive's initial views on the public policy considerations to be taken into account. The guidance also dealt with issues such as the period of the Strategic Review, public expenditure constraints and allowable financial parameters.

The detailed guidance from Ministers issued in February 2005 outlined:

- the objectives and standards that the Scottish Executive requires Scottish Water to achieve during the Strategic Review period;
- the Scottish Executive's assumptions about public expenditure and Scottish Water's borrowing limits in the period; and
- the principles that the Scottish Executive wanted to be applied in setting charge limits at the conclusion of the Strategic Review.

Regulatory returns and letters

Information is critical to effective regulation. We request information through a series of regular information returns and through regulatory letters. These regulatory requests can either be specific one-off requests or may initiate an additional regular request for information.

Annual Return

The WIC Annual Return is the largest single information request that we issue to Scottish Water each year. The format of the Annual Return is based closely on Ofwat's June Return; the information it collects is also similar, allowing us to benchmark Scottish Water with the companies in England and Wales. To ensure that the return is wholly applicable to Scotland, and that it covers circumstances which are specific to Scotland (such as PPP costs), we extended the scope of the original Ofwat return in some areas.

The Return is a robust and detailed set of information about each area of the water and waste water business and all associated costs. It consists of 12 separate sections and comprises 97 tables, with more than 20,000 items of both input and calculated information. The Return focuses in the main on information relating to the previous financial year; however in some cases it also seeks forward projections. Each line of information requested has a precise and documented definition.

We now publish the Annual Return on our website.

Monthly financial performance reports (RAB Returns)

These financial reports are submitted to this Office on a monthly basis. They provide a detailed breakdown of Scottish Water's financial performance over the preceding month and chart progress against annual budgets. This allows monthly monitoring of progress against the financial targets set out in the Strategic Review of Charges.

The format of the monthly financial report is defined in the 'WIC 25'[31] letter that was sent to Scottish Water in January 2002. The key elements of the Return are as follows.

At the start of each year:

- budget forecasts.

On a quarterly basis:

- analysis of above-ground fixed asset cost and depreciation;
- analysis of infrastructure asset cost and depreciation;
- analysis of total assets;
- cost of capital; and
- analysis of exceptional items and asset disposals.

On a monthly basis, information for the previous month (actual and budget):

- income and expenditure;
- balance sheet;
- changes in working capital;
- cash flow;
- reconciliation of operating surplus to net cash flow;
- summary analysis of fixed assets;
- income analysis – water;
- income analysis – waste water;
- analysis of operating costs; and
- audit trail of revisions to forecasts.

The financial reports form an important component of our ongoing monitoring of Scottish Water's performance. They provide a good indication of trends in performance and the rate of progress towards targets. They also supplement the information provided in the Annual Return. The accompanying commentary provides explanations for variances against annual targets and allows areas of concern to be quickly identified.

Quarterly Capital Investment Returns

An important part of the regulatory process is monitoring the delivery of the capital investment programme. It is vital that customers are aware of how effectively, and how efficiently, Scottish Water is spending this money.

Each year, in the Annual Return, Scottish Water submits detailed information about the investment carried out in the previous financial year. It also provides an investment plan for future years.

To supplement this annual information, and to provide closer monitoring of investment delivery, we also requested (in regulatory letter WIC 2) a Capital Investment Return (CIR) on a quarterly basis. The CIR provides summary information, at a project level, on the financial and physical delivery of the investment programme. For each project in the investment programme, the information provided in the CIR includes:

- forecast and actual project spend;
- explanations of financial variances;
- total forecast spend on the project;

[31] This letter is available on our website.

- investment programme budget for the project; and
- physical progress of the project against defined milestones.

Through a combination of the quarterly CIRs and the investment tables in the Annual Return, we can track delivery of the investment programme and monitor the effectiveness and efficiency of Scottish Water in delivering the required investment. The CIR can also highlight material changes from the planned investment programme. These may be positive (efficiencies or early delivery of a project) or negative (cost overruns or project delays.)

The CIR has now been brought under the auditing regime of the Reporter.

WIC 5 Customer service performance return

This quarterly information return requires Scottish Water to report on customer service performance. This is a detailed report, intended to cover the major areas of customer service. The information required in each report includes the number of:

- written contacts received by Scottish Water in the quarter;
- telephone contacts received by Scottish Water in the quarter;
- enquiries received by Scottish Water and their speed of response in the quarter;
- complaints received by Scottish Water, complaint type and speed of response in the quarter;
- telephone calls received, answering speed by call centre staff and number of calls abandoned by the customer, in the quarter;
- planned interruptions of supply, and Scottish Water's response time to these, in the quarter;
- unplanned interruptions of supply, and Scottish Water's response time to these, in the quarter;
- septic tanks emptied by Scottish Water in the quarter and their response time to requests from customers for tanks to be emptied;
- sewer flooding incidents dealt with by Scottish Water in the quarter;
- appointments kept in the quarter, where Scottish Water staff may go out to visit a customer either in the morning, afternoon or during a specific two-hour time band; and
- Guaranteed Minimum Payments made in the quarter, where Scottish Water has had to make a payment to customers for failure to meet their guaranteed minimum standards of service.

This information allows us to monitor customer service performance on a quarterly basis. It enables us to spot trends and seasonal variations and provides supporting information for analysis of particular customer service issues.

Regulatory letters ('WIC' letters)

Our regulatory letters are similar to the Managing Director (MD) and Regulatory Director (RD) letters that Ofwat sends to the companies in England and Wales. The WIC letters often ask for information relating to various aspects of Scottish Water's activities that would not otherwise be collected as part of the regulatory regime. These information requests are vital to the analysis performed by our Office.

Each letter is given a unique code and title for ease of reference and may be reissued when a request for information needs to be repeated. Where appropriate (for example with CIRs), the Reporter is asked to scrutinise the responses to WIC letters from Scottish Water. Copies of the WIC letters we issue are also sent to the Scottish Executive and are published on our website. A list of WIC letters issued to date is presented in Table 5.1. The letters are reported in full in the Appendices

Table 5.1: Summary of WIC letters

Reference	Title	Date of first issue
WIC 1	Commercially sensitive customer revenue information and data request	27 April 2000
WIC 2	Planned investment programme	2 May 2000
WIC 3	Review of infrastructure renewal and maintenance	22 May 2000
WIC 4	Household data request	8 August 2000
WIC 5	Customer service performance reports	21 June 2000
WIC 6	Quality performance assessments	22 August 2000
WIC 7	Scheme of charges 2001-02	6 October 2000
WIC 8	Dates for submission of information project data	10 November 2000
WIC 9	Non-domestic debt data request	20 December 2000
WIC 10	Information project action plan	28 February 2001
WIC 11	Not used	-
WIC 12	New opex and 'spend to save'	7 March 2001
WIC 13	Efficiency analysis: impact of PPP schemes	7 May 2001
WIC 14	Special agreements for large customers	18 May 2001
WIC 15	Capital investment and efficiencies	18 May 2001
WIC 16	Development constraints and rural sewage connections	28 May 2001
WIC 17	Data accuracy	29 May 2001
WIC 18	Quality and Standards final output	30 May 2001
WIC 19	Investment appraisal project	1 June 2001
WIC 20	Request for data relating to depots, laboratories and office buildings	6 June 2001
WIC 21	Critical information for the Strategic Review of Charges	29 June 2001
WIC 22	Customer revenue information and data request	19 October 2001
WIC 23	Capex monitoring	21 November 2001
WIC 24	Leakage	21 December 2001
WIC 25	Monthly submission of RAB tables	11 January 2002
WIC 26	Revised action plans	15 January 2002
WIC 27	Dates for submission of information to the WIC	8 February 2002
WIC 28	Procedure for information returns	2 April 2002
WIC 29	WIC Annual Return	12 April 2002
WIC 30	Accounting separation	4 October 2002
WIC 31	Dates for submission of information to the WIC 2003-04	17 March 2003
WIC 32	Quality and Standards I	11 February 2003
WIC 33	Annual Return 2003-04	11 April 2003
WIC 34	T tables 2003-04 to 2005-06	1 April 2003
WIC 35	Scheme of charges 2004-05	Not issued
WIC 36	Regulatory dialogue and progress monitoring	28 August 2003
WIC 37	Data for serviceability models	30 September 2003
WIC 38	Publication of Annual Return and investment programme information	22 October 2003
WIC 39	Ongoing development of Quality and Standards II capital investment programme	22 October 2003
WIC 40	Strategic Review of Charges 2005	12 December 2003
WIC 41	Reconciliation of WIC 18 with Finance Committee submission	2 March 2004
WIC 42	Dates for submission of information to the WIC 2004-05	8 April 2004
WIC 43	Annual Return 2003-04	23 April 2004
WIC 44	Finalisation of the WIC18 baseline for Quality and Standards II	12 May 2004
WIC 45	Draft accounting separation tables	27 May 2004
WIC 46	Strategic Review of Charges – First draft business plan submission	25 June 2004
WIC 47	Strategic Review of Charges 2006-10 – Delivery of Quality and Standards II	11 October 2004
WIC 48	Costs estimates for the Quality and Standards III Quality programme	13 October 2004
WIC 49	Proposed Schemes on Arran	15 October 2004
WIC 50	Public Private Partnership schemes	11 November 2004
WIC 51	Potential for Quality and Standards II overhang	19 November 2004
WIC 52	Trade effluent customer information	24 November 2004
WIC 53	Strategic Review of Charges – Second draft business plan submission	8 December 2004
WIC 54	Request for information relating to water and wastewater treatment plants	14 December 2004
WIC 55	Strategic Review of Charges – regulatory accounts	13 December 2004
WIC 56	Ofwat cost base for benchmarking Scottish Water's investment plan	20 December 2004
WIC 57	Corporation Tax	3 February 2005
WIC 58	Public Private Partnership Contracts	3 February 2005
WIC 59	Strategic Review of Charges 2006-10: Regulatory Capital Value and allowed Rate of Return	3 March 2005
WIC 60	Dates for submission of information to WIC 2005-06	22 April 2005
WIC 61	Annual Return 2004-05 submission	22 April 2005
WIC 62	Request for increased information on Scottish Water's 2nd draft business plan investment programme	22 April 2005

Other correspondence

We may sometimes require clarification from Scottish Water regarding a range of other issues that are not covered in the WIC letters. These are dealt with in separate correspondence. All such correspondence relating to this draft determination is available on our website.

Scottish Water's business plans

We set out a clear process and framework for the Strategic Review of Charges in the summer of 2004. This included a detailed work plan. This plan highlighted the opportunities for stakeholders to comment on our approach and to remain abreast of our thinking on the key issues addressed in this draft determination.

An important element of our approach was the submission of two business plans by Scottish Water. We issued detailed guidance to Scottish Water on the scope to be covered and information to be included in these business plans.

The business plan submissions supplemented the information contained in the standard regulatory returns and set out Scottish Water's strategy and objectives for the coming period.

Scottish Water was required to submit a first draft business plan, followed by a second draft business plan that was submitted to us and to the Scottish Executive. The process for each of these submissions was essentially the same. The first draft business plan enabled us to do much of the preparatory work for the Strategic Review of Charges 2006-10. The second draft business plan informed our conclusions on charges for this draft determination.

The timetable of key dates relating to the business plan process is outlined below in Table 5.2.

Table 5.2: Key dates in the business plan process

Date	Event
First draft business plan	
25/06/2004	WICS issue guidance on first draft business plan
05/07/2004	Scottish Water's initial issues to WICS
08/07/2004	Workshop on guidance
16/07/2004	Scottish Water's final issues to WICS
21/07/2004	Guidance to Reporter issued by WICS
28/07/2004	WICS' clarification of Scottish Water issues
01/09/2004	Draft investment plan to Reporter for audit
29/10/2004	Scottish Water submits first draft business plan to WICS
15/11/2004	Workshop on clarification of issues
23/11/2004	Scottish Water Board presentation on key strategic issues
03/12/2004	WICS' response to first draft business plan
Second draft business plan	
08/12/2004	Publication of guidance for second draft business plan
14/12/2004	Scottish Water's initial issues on guidance to WICS
17/12/2004	Workshop on second draft business plan guidance
17/12/2004	Guidance to Reporter issued by WICS
23/12/2004	Scottish Water's final issues on guidance to WICS
10/01/2005	WICS final clarification/response to Scottish Water's issues
09/02/2005	Final guidance from Ministers
20/04/2005	Scottish Water submits second draft business plan to WICS
04/05/2005	Workshop on detail of second draft business plan
12/05/2005	Scottish Water Board presentation on key strategic issues
16/05/2005	Publication of high-level summary of Scottish Water's business plan

Recommendations of the Finance Committee

In November 2003, the Finance Committee agreed the following remit for an investigation by two of its members.

"To investigate the following issues:

- **accountability** – looking at the role of the Water Industry Commissioner, the relationship with Scottish Water, the Scottish Executive and local authorities;
- **structure** – looking at water charging and debt management;
- **investment** – looking at capital projects, the profile of procurement and borrowing, billing and financial management; and to suggest potential areas for the questioning of Scottish Water and the Water Industry Commissioner.…"

The Committee published its report in April 2004. The Scottish Executive made an initial response almost immediately and a further response on 14 June 2004. We responded to the Committee at the beginning of June 2004.

The Committee's findings have been an important input to this draft determination.

Conclusion

This draft determination takes account of a wide range of information and inputs, including:

- the Scottish Executive's input through its Ministerial Guidance statements, which has been key to this draft determination;
- information that has come directly from Scottish Water; and
- the recommendations of the Finance Committee.

Chapter 6
Implications of the changing framework

Introduction

This Strategic Review of Charges 2006-10 builds on the solid foundation that was created by our 2002-06 Strategic Review. For this Review, however, we have been able to carry out more thorough analysis because there is better information now than was available to us at that time.

We have conducted this Strategic Review of Charges in line with the Better Regulation Task Force principles of transparency, accountability, proportionality, consistency and targeting.

In general, we believe that our overall approach at the last Review remains valid. However, our approach for this Review has changed in several important areas; these changes reflect both the lessons we have learned since the last Review and changes to the regulatory framework for the water industry in Scotland.

The Minister's commissioning letter for this Strategic Review outlined the changes to the regulatory framework that were taking place and stated that the Review should be consistent with those changes. We have therefore ensured a transparent audit trail.

This review focuses on Scottish Water's core activities of providing water and sewerage services to customers in Scotland. This reflects the requirements of the Water Industry (Scotland) Act 2002, which restricts our role to promoting the interests of customers of the core business.

Changes to the competition framework contained in the Water Services etc. (Scotland) Act 2005 require a greater degree of accounting separation, so there is a clear split between retail costs (customer service and billing) and wholesale costs (network management and operation of treatment plants). As a result, we are also setting both the overall level of wholesale charge and the retail charge caps at this Review.

We have also taken steps to make sure that the way we have benchmarked Scottish Water's performance is easier to understand. This has involved three main changes:

- a move towards the regulatory capital value method of price setting;
- adoption of the cash-based of financial ratios that Ofwat uses in regulating the companies in England and Wales; and
- the introduction of regulatory accounts.

Transparent audit trail

As an important first step in facilitating debate, we published a detailed work plan[32]. This set out a timeline for the remainder of the Review process.

Publication of the work plan was followed by a series of documents which provided a detailed description of the proposed methodology for the review. These methodology documents explained the factors that we proposed to take into account in determining efficiency targets, investment levels and customer service standards for Scottish Water.

In completing this draft determination, we have used information from the regular information returns that Scottish Water submits to this Office, the business plans prepared by Scottish Water and Scottish Water's responses to our regulatory letters. All of this information (with the exception of Scottish Water's first draft business plan) is available on our website.

We also published an audited version of the financial model and a detailed manual in September 2004. A final version of the model was published in June 2005. We will publish a version of the model with the information underpinning this draft determination in July 2005. A licensed copy of Microsoft Excel© is required to run the model.

In addition, in December 2004 we published a report from an external expert (ING Barings) on financial ratios and borrowing in the water industry. In May 2005 we published our response to the methodology consultation, including a copy of the consultation responses we had received.

During the past year we have held a series of workshops and stakeholder information days so that interested

32 Water Industry Commissioner for Scotland, 'Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges', July 2004.

parties could seek clarification and express their views. Details of these events were contained in our work plan, and we contacted a large number of stakeholders before each event to let them know they were taking place. A summary of these meetings is available on our website.

We discussed the changes in our approach to charge setting at this Review in our methodology consultation and at the stakeholder information days. These discussions have included in particular the three main changes in our approach, which are discussed below.

The regulatory capital value approach to price setting

Ofwat uses the regulatory capital value approach in setting prices for the companies in England and Wales. We believe that we now have sufficient information about Scottish Water's assets and their remaining lives to begin to move towards this method of charge setting. It is important to understand that for the purposes of this Strategic Review of Charges we are laying the ground for the future use of the RCV.

Our approach requires us to set an initial RCV for Scottish Water. Scottish Water will receive an appropriate rate of return on this RCV. Efficient investment in new assets will be added to the RCV. Depreciation (reflecting the costs of using existing assets) reduces the RCV but its cost will be covered in the annual charge limit.

These changes will be limited to the approach to meeting the costs of new and existing assets. Our move towards this new approach will have no material impact on the charges faced by customers, the resources available to Scottish Water, or the level of public expenditure. The changes are designed principally to allow greater transparency. They will bring the approach to charge setting for Scottish Water into line with that for the English and Welsh water and UK energy sectors and will allow us to make a direct comparison of Scottish Water's financial sustainability with that of the companies south of the border.

Beginning to move towards the RCV method of price setting allows us to make a direct comparison of Scottish Water's financial sustainability with that of the companies south of the border.

We consulted on our approach to establishing the initial RCV for Scottish Water as part of our methodology consultation. We explained that there are four broad approaches that regulators can use to establish the initial RCV of a regulated utility in the private sector:

- **an accounting approach** – the RCV takes into account the asset value of the company;
- **a market value approach** – the RCV adopts the value placed on the company by the financial markets;
- **a comparator approach** – the RCV is set by making a comparison with the RCV of a similar company; and
- **a discounted cash flow approach** – the RCV is calculated by using financial valuation techniques.

Most UK regulators have used the second approach to estimate the initial RCV of the regulated business. It is obviously not possible to apply this method for a public corporation such as Scottish Water.

In 2009-10 we wanted the RCV to be sufficient to ensure that if Scottish Water met its obligations under its regulatory contract, then it would comply with all of the targeted financial ratios. The initial RCV was backwards calculated on the allowed investment programme, our inflation expectations and our allowances for depreciation.

We checked this initial RCV with a range of comparisons including:

- relative asset bases (in terms of both value and structure);
- non-infrastructure capital investment;
- Welsh Water's debt to RCV ratio;
- the companies' funding costs to RCV ratio (ie debt and dividends); and
- assets relative to the type and number of customers served.

This analysis showed that the initial RCV was reasonable[33].

Financial ratios

Following its inquiry into the water industry in the first quarter of 2004, the Finance Committee of the Scottish Parliament concluded that the way we use financial ratios should have been more transparent.

The RCV method of price setting that we have begun to introduce will make the process of comparing financial performance more straightforward.

We have adopted the cash-based ratios that Ofwat used in its price determinations for 2005-10. We have set charges using the key ratios that Ofwat targeted in its review as constraints. In other words, we set revenue in the final year of the draft determination to ensure that Scottish Water's financial health met the standard required by Ofwat's key ratios. Where Ofwat has stated that a target is 'around' a certain level, we have assumed that the ratio for Scottish Water should be within 25% of the target.

We have also published the two debt payback period ratios and the cashflow to capital expenditure ratio that Ofwat used for the 2000-05 regulatory period. We believe that it is desirable for Scottish Water to remain broadly compliant with these guidlines. We have not, however, amended charge limits in order to comply with the targets for these ratios. This reflects the capital market's view that these ratios are now outdated. We believe that it is useful to continue to monitor these ratios to ensure consistency in our approach to financial sustainability.

In their Ministerial Guidance, Ministers stressed the importance to customers of stable charges. Accordingly, we have proposed charge caps in the first three years of the regulatory control period that ensure a smooth transition to the level of prices required in 2009-10.

Our analysis also suggested that this approach reduced the risk of substantial real charge increases in the 2010-14 regulatory control period.

[33] This is discussed in detail in Chapter 20 of Volume 5.

Introduction of regulatory accounts

Why we introduced regulatory accounts

The Strategic Review of Charges 2002-06 covered both the core and non-core activities of Scottish Water (and the three former water authorities). It was based on financial information provided by the three authorities, including information from their statutory accounts.

As the 2002-06 Review was based on information contained in the statutory accounts of the three water authorities, we knew that we would need to adjust the information reported to us by Scottish Water in order to ensure that our assessments of its progress year-on-year and against targets were properly objective. Such adjustments may be necessary because the level of operating cost can be influenced by management's interpretation of changes in accounting policy and practice. Although these adjustments may be perfectly in line with statutory accounting rules we need to unwind them in order to be able to make like-for-like comparisons over time.

Regulatory accounts keep to a minimum the need for, and extent of, such adjustments by determining in advance the basis on which numbers are reported.

In early 2003, Scottish Water submitted its proposed business plan for the three-year period from 2003-04 to 2005-06. In March 2003, the Minister wrote to this Office asking us to consider representations from Scottish Water about its strategic business plan. In particular, the Minister noted that Scottish Water's proposed business plan suggested that its operating cost targets would be different from those set out in the Strategic Review of Charges.

We received written representations from Scottish Water. In our response to Ministers we pointed out that the operating cost projections contained in the strategic business plan would have led to charge increases of around £40-£50 in 2006-07 for the average household customer.

The ten principles

We worked with Scottish Water to understand its representations and make an appropriate revision to its efficiency targets. During the spring and early summer of 2003 we developed the 'ten principles' with Scottish Water and the Scottish Executive. These principles set out a range of measures to improve information flows and clarify both Scottish Water's efficiency targets and the nature and scope of any adjustments that are made for the purposes of comparison.

This agreement also led to the introduction of regulatory accounts. This was an important step forward in ensuring that our monitoring is more robust.

Implications of the Water Industry (Scotland) Act 2002

In the last Strategic Review of Charges, we commented on the advantages to be gained from proper accounting separation between Scottish Water's core and non-core activities. We were pleased when the Water Industry (Scotland) Act 2002 limited the remit of this Office to promoting the interests of customers of the core business.

Core activities need to be separated and appropriately ring fenced, so that we can properly promote the interests of customers of the core business. The introduction of regulatory accounts has significantly improved clarity when defining the separate activities. Until they were introduced, only a limited and approximate measure of separation was possible, through unaudited reporting of non-core costs and revenues by Scottish Water in annual regulatory returns. This arrangement was problematic as:

- although core activities are defined by legislation in general terms, there were no agreed definitions of exactly what constitutes core activities;
- the Strategic Review of Charges 2002-06 dealt with all areas of business, both core and non-core, and was published before the 2002 Act; and
- we had to adjust reported numbers to accommodate ongoing changes in the scope of non-core activities since the Strategic Review of Charges 2002-06.

Regulatory accounts facilitate more effective benchmarking

The economic regulators establish and define the guidelines for regulatory accounts. Regulatory accounts do not necessarily follow the standard accounting guidelines (FRS, UKGAAP, etc) that are used for statutory financial accounts. Indeed, in their common principles[34] the regulators agreed that in the event of a conflict between regulatory accounting guidelines and UKGAAP, the regulatory accounting guidelines would take precedence.

Regulatory accounts are designed to provide a representative picture of performance in the context of the economics of the particular regulated sector. Each regulator therefore sets out specific guidance for their sector. The specialist nature of regulatory accounts allows much tighter definitions of reporting requirements to be specified. In contrast, UKGAAP must be sufficiently flexible to deal with a full range of types and size of business. The tighter definition allowed by regulatory accounts allows comparisons of performance both over time and between companies.

Regulatory accounts cover all aspects of the water and sewerage companies' finances in England and Wales. This comprehensive information allows Ofwat to compare financial performance fully and objectively, and to set appropriate targets for efficiency, capital investment and sustainable financial indicators. The introduction of regulatory accounts for Scottish Water has allowed us to propose appropriate targets.

The introduction of regulatory accounts should significantly reduce the need for adjustments to Scottish Water's reported costs in the 2006-10 regulatory control period.

[34] 'The role of regulatory accounts in regulated industries, a final proposals paper by the Chief Executive of Ofgem, Director General of telecommunications, Director General of water services, Director General of electricity and gas supply (Northern Ireland), Rail Regulator, Civil Aviation Authority, and Postal Services Commission' – page 5.

Licensing framework

Changes to the competition framework that are contained in the Water Services etc. (Scotland) Act 2005 required a further level of accounting separation. This framework requires a clear split between the retail costs (customer service and billing) and the wholesale costs (network management and operation of treatment plants).

We have used the regulatory accounts to ensure that we can distinguish clearly between the retail and wholesale costs. This will ensure that customers benefit to the greatest extent possible from the proposed changes.

The regulatory accounting guidelines define the retail and wholesale activities in significant detail. There are also rules set out, as part of the regulatory accounting guidelines, that determine the allocation of central overhead costs between the wholesale and retail business and the general trading relationship between the two legal entities. We will ask the Reporter and Scottish Water's auditor to report on Scottish Water's compliance with these rules.

Conclusion

We have made a number of changes in our approach to the Strategic Review of Charges 2006-10. Wherever possible we have taken account of stakeholders' views on the Strategic Review of Charges 2002-06.

In particular, we have moved towards the RCV method of price setting for this draft determination. This allows more immediate comparison of financial performance between the privatised industry south of the border and Scottish Water. Such comparison is facilitated because we have adopted the Ofwat cash-based financial ratios as constraints on price. We have also ensured that monitoring over time is facilitated by continuing to measure Scottish Water's compliance with the debt pay-back ratios that underpinned our advice in 2001.

We have sought to adopt the Better Regulation Task Force principles in setting charges. In July 2004, we published a detailed work plan for the review and highlighted the opportunities for stakeholders to learn about or comment on our proposed approach. Detailed information relating to the Strategic Review of Charges 2006-10 (including our financial model and requests for information) has been placed on our website.

The Water Industry (Scotland) Act 2002 and the Water Services etc. (Scotland) Act 2005 have strengthened the regulatory framework and should ensure that customers in Scotland can look forward to stable charges and better value for money. These changes have required us to introduce regulatory accounts. These should improve the transparency of our comparisons of performance between Scottish Water and the companies south of the border.

Chapter 7
Critical issues

Introduction

This chapter highlights some of the critical issues that have had an impact on the level of charge caps set in our draft determination. Customers have the right to expect that the service they receive is provided efficiently. In this regard, it is particularly important that investment in improving the environment, public health and the level of service to customers is delivered according to the agreed profile. We believe that customers should not pay twice for any promised improvement; this draft determination sets out a clear process that will protect customers from any shortfalls in performance from Scottish Water.

In the long run we believe that customers' interests are best served by a financially sustainable Scottish Water, operating within an effective and balanced governance and incentive framework. This will ensure that each generation of customers meets the costs of the level of service they have enjoyed.

We have proposed charge caps that ensure Scottish Water ought to comply with the targeted Ofwat financial ratios and that have taken account of the reasonable required overall level of operating costs and capital investment (such that Ministers' objectives can be delivered). The charging regime has been developed to smooth out year-on-year volatility.

In regulating Scottish Water, we are interested not only in the level of cost incurred but also in the level of service provided to customers.

The Strategic Review of Charges 2006-10 does not end with the publication by the new Water Industry Commission of the final determination at the end of November 2005, or even with the approval of the scheme of charges that takes effect from 1 April 2006. The Commission will monitor and report on Scottish Water's performance during the regulatory control period. This monitoring is important because it will identify whether the future charge profile for 2010-14 indicated in this draft determination is likely to be deliverable.

Efficiency

The principal statutory function of the Water Industry Commissioner for Scotland is to promote the interests of customers. This is achieved primarily by encouraging Scottish Water to deliver an appropriate level of service at the lowest sustainable cost.

The costs of providing the service can be broken down into operational costs (the costs of running the system), capital costs (maintaining, replacing and upgrading the assets) and financial costs (the costs associated with debts and funding working capital).

Funding the costs of maintaining the system ultimately has to come from customers. If money is borrowed, the cost of this borrowing has to be met by customers both in the present and in the future. If the Government provides a grant to the water services provider, the money for this grant also comes ultimately from the taxes customers pay. Either taxes would have to increase to meet this cost, or funding for other central government services would have to be reduced. The customer interest is therefore clearly served by Scottish Water delivering its service efficiently.

Efficiency is often taken to mean cutting the costs of providing a service. This is, however, too simplistic a view because an assessment of efficiency should also take account of the service that is actually being provided. Water and sewerage undertakers in the UK must provide the minimum standard of service that is expected by stakeholders. This includes treating drinking water to the minimum standard required by legislation and removing and disposing of effluent in compliance with the minimum standards required by legislation.

An efficient water and sewerage undertaker will carry out the minimum activity necessary to provide the service that is expected, at the lowest cost.

An inefficient water and sewerage undertaker may be inefficient for one of two reasons:

- Case A – the organisation carries out more activities than are necessary in order to provide the expected standard of service. Even if the organisation is generally low cost, this would tend to increase the cost of providing the service. Even if these extra activities raise the standard of service above that which stakeholders expect, we would still consider this organisation to be inefficient.

- Case B – the organisation carries out the minimum activities that are necessary in order to provide the expected standard of service, but at a high cost.

In Case A, the organisation has chosen to provide a higher standard of service than is actually expected. Customers should not be expected to pay for the costs of providing this high standard of service, unless they have previously indicated a willingness to pay for it.

In Case B, the organisation provides the minimum expected service, but at a relatively high cost. Once again, customers should not be expected to pay more as a result of their undertaker's inefficiency.

An efficiency can therefore only be claimed when the costs incurred in delivering a defined level of service to customers are reduced or when there is an improvement in the level of service to customers with no additional costs incurred.

This definition applies equally to both operating costs and capital expenditure. In capital expenditure, we define efficiency as delivering the same level of investment outputs for less expenditure or delivering a higher level of outputs for the same expenditure.

At the Strategic Review of Charges 2002-06, our primary focus was on the former, ie delivering the same level of outputs that was originally proposed in the Quality and Standards II process, but for a lower level of expenditure.

In the Strategic Review of Charges 2006-10, we have again focused on ensuring the delivery of the Ministers' objectives for the lowest reasonable overall cost. We have set out to be clear about the actions that would not be consistent with our definition of capital expenditure efficiency. These actions include the following:

- Deferring a project: it is not acceptable simply to defer a project that is included in the Quality and Standards investment programme in order to claim an efficiency. Even if a new derogation has been negotiated, no further funding would be allocated in future charge caps to allow for a deferred scheme to be completed unless some new output has been substituted for the original project; and

- The 'do nothing' option: it is unacceptable simply not to complete a project unless the required output can be delivered in some other way.

The charges paid by customers are a direct function of the efficiency of the water industry in Scotland.

Delivery of investment

It is critical that assets are maintained in an appropriate way and that problems are not stored up for the future. If assets are not maintained appropriately, this increases the cost of environmental/public health compliance and improvements in customer service. This in turn is likely to reduce customers' willingness to pay for improvements. We have ensured that sufficient funding has been made available at least to maintain the serviceability of assets.

The condition of the assets should be monitored regularly, so that investment takes place at the point where the cost of ensuring that an asset can perform adequately exceeds the annualised costs of replacing or refurbishing the asset. In this way, customer charges over the medium to long term are kept to a minimum and service levels are maintained.

In their February statement, Ministers set out their priorities for the water industry in Scotland during the next regulatory control period.

There have been significant increases in customers' bills in the past few years. In general, customers have accepted that there is a need to invest in our water supply and water environment. However, if promised outputs are delayed this could have an impact on customers because there is a higher risk that an output will not be delivered in full or that it will cost more to deliver. Customers are likely to question why promises of improved service levels have not been delivered yet bills have gone up.

At the start of Quality and Standards III we made it clear that we would require a transparent investment programme that is open to audit. A detailed baseline programme brings significant benefits for customers. Capital projects such as treatment plant upgrades or pipe renewal can have a major impact on customers and their local communities, and customers have a right to information about projects that will impact on them.

We have therefore published the baseline investment programme that has been funded in this draft determination. If customers have been told by Scottish Water that levels of service will improve as the result of a particular project, they should be able to check if and when that project has been delivered. This will help ensure transparency and accountability in the delivery of agreed benefits to customers and to the environment.

Similarly, if customers are to receive value for money it is vital that the large quality investment programme is properly defined. In our view, this baseline investment programme will need further definition in a number of areas if we are to be able to monitor it properly

Improvements in customer service

We explained earlier that it can be difficult to measure customer service performance. Important factors such as the number of properties at risk of sewer flooding or experiencing water pressure problems require engineering judgements. It can take several years, using a consistent approach to monitoring, before we can measure performance on individual parameters accurately and with confidence.

Scottish Water provides this Office with customer service information on a quarterly and an annual basis. The lack of reliable information from Scottish Water currently restricts our ability to understand Scottish Water's actual customer service performance at a detailed level. We can be confident, however, that there is a considerable gap in performance between Scottish Water and the industry south of the border. The gap in performance cannot reasonably be accounted for by the scope for error in measuring levels of service either side of the border.

Our monitoring will ensure that the levels of service included in this draft determination are delivered. If there is a shortfall in delivering customer outputs that have been funded in this draft determination, we will adjust the determination accordingly at the next Strategic Review of Charges.

Effective governance and incentives

We wrote a second open letter to Ministers in May 2005. This letter addressed issues arising from the use of incentive-based regulation to set charge caps for Scottish Water. This letter suggested that the performance of management should be judged by the extent to which they out-perform the regulatory contract. This letter is published on our website.

Establishing financial sustainability

In the Strategic Review of Charges 2002-06, we showed that in previous years the Scottish water industry had spent considerably more than it had received in customer charges. We explained that this was a problem because it was likely that high levels of investment were likely to be required for the foreseeable future. It would only have made matters worse to continue to increase net borrowing significantly in order to eliminate the gap between revenue and expenditure. Borrowing may have delayed a charge increase, but it would have increased future bills by the interest payable on any additional borrowing.

In providing our advice on the level of revenue, we took into account a clear concern from customers that the industry needed to 'get its house in order'. Customers also suggested that as a commodity business, Scottish Water should be able to operate sustainably without real increases in charges.

We believe that the revenue increases that we implemented in the Strategic Review 2002-06 have ensured that we now have a more sustainable industry. Customers will begin to enjoy the benefits of this in the 2006-10 regulatory control period.

If customers are to continue to benefit from a sustainable industry, we must ensure that we invest appropriately in water services. This means that a generation should pay the full costs of the service that it receives and should not store up problems for future generations. The introduction of a charge setting mechanism that is tied to changes in, and the funding costs of, the regulatory capital value will make this more transparent.

Financial sustainability is critical to the success of the public sector model. In the public sector model, the Government wants best value for money for customers and to ensure that social, environmental and public health policy priorities are delivered.

Rigorous monitoring

Where prices are regulated the company may have an incentive to meet cost reduction targets by reducing quality.

As previously outlined, improved efficiency implies either a higher quality output for the same charge or the same quality output for a lower charge. Regulators therefore monitor and report on the levels of service provided to ensure that the cost savings being made by the company are sustainable and will benefit customers. It is not in the customer interest that budgetary pressures result in corners being cut either in customer service or in the way the asset base is maintained.

It is important that we are able to measure levels of service to customers in an objective and consistent way, both now and in the future. This requires us to set out in detail the areas of service that we will measure and how they will be measured. We describe the targets that we will be monitoring in this draft determination. We have endeavoured to ensure that we measure the factors that are important to customers and that customers can understand our analysis of Scottish Water's performance.

Our work in scrutinising costs and the levels of service delivered is key to our role in ensuring that customers receive value for money on a sustainable basis. We believe that this detailed monitoring ensures that we have fulfilled our statutory duty to have regard to "the economy, efficiency and effectiveness" with which Scottish Water is using its resources.

Customers only pay once for an agreed output

Regulation has introduced much needed transparency to the assessment of the performance of the Scottish water industry. In the past it was not clear whether customers had received the benefits which were promised and for which they had paid. For example, in the last Strategic Review of Charges, we raised concerns about the level of scrutiny and challenge given by the former authorities to projects as they passed through the project appraisal process.

We have developed our performance monitoring significantly in the last three years. Our more detailed monitoring of the capital programme will also ensure that we can manage the transition from the Quality and Standards II to the Quality and Standards III period effectively.

This monitoring is likely to be critical since we expect that more than £250 million of Quality and Standards II investment may not have been delivered before the start of the Quality and Standards III period.

We have subtracted these outputs from the initial RCV. We will then add this back to the RCV as the investment is delivered. Quality and Standards II additions will be depreciated once they are added.

Moreover, we have made it clear both in this draft determination and in an open letter to the Minister[35] that if Scottish Water underperforms the targets set in the Strategic Review of Charges 2006-10, we would expect Ministers to decide on an appropriate course of action. In our view, customers should not be asked to pay twice for the same benefit.

[35] Open letter to Minister dated 2 December 2004; is available on our website www.watercommissioner.co.uk

Water Industry Commissioner for Scotland
Ochil House Springkerse Business Park Stirling FK7 7XE
telephone: 01786 430 200
fax: 01786 462 018
email: draftdetermination@watercommissioner.co.uk
www.watercommissioner.co.uk

June 2005