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Dear Katharine

Consultation – Strategic Review of Charges 2010-14

Water UK represents all UK regulated water and waste water service providers at national and European level.

Regarding the process of your consultation, we have welcomed your commitment to stakeholder engagement and clarity of documentation. We hope you will continue to evaluate your process of consultation with stakeholders. In particular, we would in future welcome more timely posting of reports from workshops on your website and perhaps some form of commitment to on-going dialogue.

We are pleased to respond to your consultation as follows;

Volume 1: Financing & governance of Scottish Water

Q1 Do respondents agree that the level of operating risks faced by Scottish Water is broadly similar to those faced by companies south of the border if not, how are they different and how should this be allowed for in prices?

Comparing the risk of Scottish Water with that faced by companies in England and Wales is complicated by the different ownership, political context, vertical structures and regulatory incentives. The Commission will need to consider these various factors and their impact.

One specific example is that the removal of council tax may result in considerable additional costs on Scottish Water for collection of charges. There is also a risk of a reduction in revenue as a result of customers ‘slipping the net’. These may need to be reflected in arrangements for logging up/ interim determinations.

Q2 Do respondents agree that using proper comparisons with England and Wales remains the most effective way to regulate Scottish Water? If not, how should we set prices and measure levels of service?

We agree in principle that regulation can be enhanced by robust, transparent and proportionate use of comparative data. In comparing Scottish Water with England and Wales, there will be advantages in pursuing a consistent regulatory approach, but this need not mean the wholesale adoption of the same methodologies. The Commission will need to take into account fundamental differences between the sectors, for instance, the disaggregation of Scottish Water into wholesale and retail and the public sector characteristics of the Scottish industry – for instance, that it has to meet Ministerial objectives rather than follow guidance as in England and Wales.

Q3 Given that we have a duty to promote the interests of customers, are we taking sufficient steps to protect customers from unnecessary risks? If not, what other steps should we be taking?

We believe that the Commission has set an appropriate framework for dealing with risk at the last price review, in particular in introducing the logging up & IDoK mechanisms and the development of the ‘gilts buffer’. As ever the devil will be in the detail.

We would like the Commission to ensure that domestic customers are not disadvantaged by the new competition regime.

Q4 Do respondents agree with our use of the RCV, ‘gilts buffer’ and rolling incentives?

Using the RCV and ‘building blocks’ approach benefits from being broadly consistent with the regulatory approach in England and Wales. However, we would welcome more transparency about how the approach will work in practice. In particular you propose an alternative approach to the cost of capital, giving a primary role to credit ratings. We welcome your indication that nonetheless you wish to ensure your approach is consistent with a conventional Weighted Average Cost of Capital Approach. (WACC). However, it is not clear how you propose to achieve this. It will not be sufficient, indeed it may even be misleading, to suggest (whether explicitly or implicitly) that the returns calculated by your method, when divided by the RCV, can be regarded as a 'WACC' figure. To ensure consistency it will be important to ensure CAPM and financial ratios are kept as a cross check, by giving separate weight to market evidence on the cost of debt and equity.

The 'gilts buffer' is a useful insurance for customers in the absence of an equity buffer but it is essential that it is 'ring fenced'. The purpose to which outperformance gains should be put, and when, should be a matter, not for the regulator, but for consultation by the owners and SW with SW customers.

The Commission suggests that managerial incentives might be linked to out performance as reflected in growth in the gilts buffer. This recognises the importance of aligning managerial incentives with business objectives but again it will be important to sort out the detail.

Generally, we look forward to greater transparency about the Commision's proposed approach following this consultation.

Volume 2: Customer revenue, levels of services & the new competition framework

Q1 What are respondents' views on our approach to establishing the revenue and customer baseline for the Strategic Review of Charges 2010-14?

It will be important that Scottish Water has incentives and funding to ensure the quality of data particularly in the light of possible introduction of local income tax instead of council tax

It will also be important that careful consideration be given to the role of the Central Market Agency in holding data on non-household customers and how the transfer will be made.

Q2 What are respondents' views on our proposals to encourage Scottish Water to continue to improve the level of service it provides to customers?

We recognise the Commission's arguments for continuing broadly to use the Overall Performance Assessment (OPA) as a mechanism to incentivise customer service improvements – in particular that SW still has a way to go to catch up with companies in England and Wales. However, we would encourage the Commission to look more broadly at the question of incentivising customer service and in particular incentive schemes that recognise the price-service trade off.

In England and Wales, it has become clear that the OPA may have reached the end of its shelf life and Ofwat is itself committed to a review. Driving this is the recognition that differences between companies have considerably narrowed at the top of the performance spectrum on the existing measures, and that the measures are not necessarily in tune with what really matters to customers. Not least there is no connection between the measures and customers' willingness to pay for different attributes, nor do the measures relate to what drives 'customer satisfaction' more broadly. Companies and customer representatives appear broadly in agreement on these general points. We believe the on-going joint research with Waterwatch Scotland will make a positive contribution to this approach and that there should be a development towards more qualitative assessments.in respect of customer experience.

Q3 How do respondents view the changes we are making to reflect the new competition framework?

The default tariff must be aligned with a clear defined level of service in the licence so that non-household customers are not disadvantaged. The Commission has already expressed the view that competition will be beneficial in terms of prices and service for domestic customers of Scottish Water. The Commission must also ensure that competition and in particular 'cherry picking' does not have the opposite effect and disadvantage domestic customers

Volume 3: Approach to assessing operating cost efficiency

Q1 Do respondents agree that our approach to benchmarking Scottish Water's performance remains robust despite the separation of non-household retail activities in Scotland?

Regarding the proposal to include SWBS costs in SW's cost base, whilst we understand the logic, we think this needs careful consideration, from the point of view of how it will work and impacts on incentives. We would caution against over complicating the approach to efficiency which is already highly complex, and impenetrable to some (as noted by the Competition Commission in its reports on Mid Kent and Sutton and East Surrey). The Baker review of PR04 also highlighted the complexity of

Ofwat's current approach (on which the Commission models its own approach) and asked whether PR04 could have been carried out less data intensively.

There would also need to be some consideration as to how special licences in respect of S29E would operate given that they suggest a lower level of customer service would apply.

Q2 Do respondents agree that we should take account of differences in the level of service and scope of activities in Scotland and in England and Wales?

We note that within the England and Wales sector there is also a range of differences in scope of activities (and to a lesser extent customer service, at least as presently measured by OPA). This could well increase in future, not least given the differential impact of water resource and quality drivers, climate change and population growth, and given that companies are being urged to develop business plans in line with local customer expectations, priorities and willingness to pay. We believe this will increasingly call into question the reliance of Ofwat on its present comparator-based approach to regulation. The Commission's question needs to be considered against this background.

Q3 Do respondents agree with our favoured approach to setting an appropriate efficiency challenge for Scottish Water?

The WIC approach to benchmarking appears to be highly dependent on an econometric modelling approach, drawing heavily on the Ofwat framework. There are dangers in taking this too far, given the accepted limitations of such modelling (see for instance the recent UKWIR report on approaches to efficiency by consultants, 'Reckon'). Output from modelling approaches needs to be used in a proportionate way alongside other evidence. The complexity of the approach is also of questionable value as has been repeatedly highlighted (see above). Transparency both in the modelling and how the outputs are used to form regulatory judgements on efficiency and targets is crucial.

Finally, we note that the Commission is not proposing to set SW an efficiency target based on the Ofwat approach of frontier shift plus catch-up. We do believe there are real questions, on a priori grounds and empirically, about whether it is valid to assume that water companies, whether England and Wales or Scotland can be expected to continue to outperform the economy as a whole on an indefinite basis. As such we note that in the present review of airports, neither the CAA nor the Competition Commission have considered it appropriate to assume any frontier shift driver for efficiency.

Q4 Do respondents agree that our approach to assessing claims for special factors is reasonable?

On special factors, we note the conclusion from the recent UKWIR (UK Water Industry Research) joint research project on efficiency[1] that these should be taken into account as far as possible upfront in the modelling approach, rather than as an ex-post adjustment. A further UKWIR research project is presently underway to develop this into practical proposals. We recommend that the Commission take this strand of methodology development on board.

Volume 4: Approach to capital expenditure

Generally we are somewhat struck by the level of detail to which the Commission is involved in the assessment of Scottish Water's capex programme. This may reflect the nature of the regulatory relationship (one-on-one) in Scotland and the political/institutional context. However, we would urge the Commission to consider carefully where the divide lies between effective regulation and micro-management that can damage managerial incentives on Scottish Water. This is perhaps particularly the case with regard to the planning and execution of capital maintenance.

On the use of Common Framework we note the Commission's view that 6-8 years of data is required, however experience in E&W suggests that a longer time period may be more realistic.

We also note that there is little reference in this section on assessing customer preferences, willingness to pay or the role of cost benefit analysis in establishing appropriate investment programmes for Scottish Water. This is viewed as a key development in the England and Wales sector to ensure that customers receive the services that they value. Again, we would urge, above all, that the Commission develops a transparent approach in making its assessment of capex programmes.

[1] 'Review of the Approach to Efficiency Assessment in the Regulation of the UK Water Industry' , Reckon LLP, 2006

Q1 What are respondents' views on how we propose to assess the size of investment programme that Scottish Water should be expected to deliver efficiently?

We understand the concerns regarding potential capacity constraints, in the context of a number of large engineering projects in UK eg Olympics, Commonwealth games, rail and tram infrastructure, new Forth Bridge etc.. Where important these should be factored into considerations both of the scale and pace of the capex programme and expectations of efficiency. The potential use of long term frameworks is a matter for management of SW.

Q2 Do respondents have views on how we propose to define the scope of the investment programme required to deliver ministerial objectives for the water industry.

See general comments on Section 4 above. In addition, we have some reservations about the proposed extended role of the Reporter and its influence on the scope of the programme. We believe this is the role of the major stakeholders such as SEPA and DWQR.

We believe that it is also important to consider other impacts of the investment programme particularly in respect of sustainable development and carbon emissions. We are concerned that there is no discussion in the methodology of how climate change mitigation or adaptation is to be addressed or the impact of the forthcoming carbon reduction targets regime. Evidently there remains much uncertainty around these issues, but it would be helpful for the Commission to set out its initial thinking in these areas. The programme should include consideration of these aspects over a long-term timescale.

Also, how quality programmes are squared with the potential impact of end of pipe solutions on climate change is an important issue that the water industry faces in general. Recent flooding events in the UK have highlighted the need to consider very carefully the resilience of networks and how this is maintained in the future in a timely and efficient manner to underpin the delivery of essential water and sewerage services.

We are disappointed to note that the word 'sustainability' is markedly absent from the Commission's documents in general.

Q3 What are respondents' views on how we propose to determine an appropriate allowance for capital expenditure?

There appears to be excessive reliance on the Ofwat models especially for capital maintenance, which are widely accepted to be the least robust.

Q4 Should we consider an application by Scottish Water for an 'early start' to delivering the required investment outputs for 2010-14?

Stop-start investment, stimulated by the regulatory cycle, is a problem that we recognise and we welcome initiatives that address it.

If an early start programme is to work in Scotland, we conclude that this will require the ability to identify, and agree, in advance projects that it is clear will be needed. We understand that this is well advanced in Scotland and that the Quality & standards process is in place to facilitate this process. For capital maintenance, this is essentially down to Scottish Water. The 'Breaking the Cycle' initiative from Scottish Water appears a positive attempt to build on these opportunities and we fully support their proposals in this respect. There may be other lessons that may be drawn from the recent collaborative UKWIR/Ofwat/British Water/SBWWI report on the Regulatory cycle[2].

Q5 Are the methods that we propose for monitoring Scottish Water's performance in delivering the outputs required by the regulatory contract appropriate?

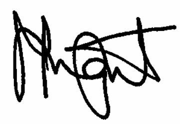
Monitoring performance against objectives and specific outputs, and providing transparency to stakeholders on progress, is an important element of regulation. The Output Monitoring Group in Scotland provides a mechanism for doing this that has much value. On the surface however, there does appears to be a tendency to be intensive and detailed, if not quite 'micromanagement'. Whilst this might reflect the different operating environment in one-on-one regulation, with public sector ownership, we would recommend that WIC and other stakeholders keep a watching brief on how far this mechanism needs to extend into the day to day business of Scottish Water. The reports that are produced have generally been welcomed by all parties in providing transparency. Their timing, content and format could usefully be kept under review, to ensure

[2] 'The Regulatory Cycle and Its Impact on the Efficiency of Supply Chain Delivery', Mouchel Parkman, 2007

that monitoring remains focused and effective, taking into account the availability of data.

We would be pleased to discuss any of our points in more detail with you.

Yours faithfully



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