

**Minute of the thirteenth meeting of the Water Industry Commission for
Scotland
Held on 7 and 8 March 2006 in Stirling**

In attendance

Commission: Sir Ian Byatt (Chairman)
Professor David Simpson (Deputy Chairman)
Professor John Banyard
Dr Michael Brooker
Mr Charles Coulthard
Mr Alan Sutherland (Chief Executive)
Mrs Katherine Russell (Secretary to the
Commission)

Miss Harriet Towler

Apologies for absence: None

Chairman's opening remarks

The Chairman welcomed everyone to the meeting and thanked them for attending.

Minute of previous meeting and review of action points

The Commission agreed that the minute of the previous meeting was an accurate account of proceedings.

The Commission requested an information note about the tendering process that had been used for the office's newly appointed framework contractors. It was noted that no member of the Commission, excepting the Chief Executive, had been involved in the tendering or the decision process. **Action**

The Commission noted those actions from previous that had yet to be completed and would be carried over to future Commission meetings.

Update on current issues

The Chief Executive updated the Commission about his recent meeting with the Scottish Executive to discuss the timeline for the next Strategic Review of Charges and the Quality and Standards IIIb process. He noted that it had been recognised that the timescale was challenging, and that the process would have to make significant progress in the coming months.

The Commission believed that it would be important that progress with Quality and Standards IIIb was closely integrated with the work of the High Level

Monitoring Group (HLMG). In particular, it believed that the HLMG should have visibility about future investment plans and that this should be considered for the terms of reference for the group. It would also be important to ensure that the group met at the earliest possible convenience.

It was noted that a meeting had been arranged with Scottish Water to discuss leakage and drainage area studies.

Professor Simpson noted that he had continued to build positive links with universities in order to further graduate recruitment. The Chairman noted his thanks for this effort.

Mr Coulthard noted that he had enjoyed attending the recent Ministerial launch of Waterwatch Scotland. He also updated the Commission on the latest meeting of the Audit Committee, noting that the minute of the meeting would be circulated at the next Commission meeting. **Action**

The Chief Executive noted that he would shortly meet with Scottish Water to discuss the presentation of financial information, including accounting conventions, for its delivery plan.

The Chairman noted that he and the Secretary to the Commission had recently held meetings with the FSB (Federation of Small Businesses) and the former convenor of the large users group. He had also held meetings with George Lyon MSP and with John Mason of the Scottish Executive.

Update on office workplan

The Chief Executive updated the Commission on progress with the office workplan. The Commission agreed that work on the Overall Performance Assessment (OPA) should be prioritised in the workplan in the coming months. The Commission agreed it would be important to reinforce the OPA milestones set for Scottish Water in the Final Determination by devising a publicly available information note. Consideration should also be given to how the OPA could evolve for future monitoring. **Action**

Capital delivery quarter 3 update

The Chairman welcomed Mr Ian Tait to the meeting to discuss the implications of Scottish Water's latest Capital Investment Return. The Commission noted that there was evidence that the size of the Quality and Standards II overhang into the Quality and Standards IIIa period was increasing. Whilst it agreed that this may prove to be a timing issue, and that the size of the overhang could be as assumed in the Final Determination, should it prove otherwise this would materially increase the efficiency challenge facing Scottish Water. In turn, this could result in additional funding being required. The Commission noted that this additional funding would not be provided by customers through charges as they had already paid for Quality and Standards II outputs to be delivered.

The Commission agreed Scottish Water would be informed of the analysis undertaken using its investment returns and highlighting the above issue.

Action

The Commission discussed the difference between measuring outputs (solutions) and objectives, noting that before any outputs from the investment programme could be defined as delivered, they should first be verified by the quality regulators as meeting specified standards. They noted that to incorporate this information a change to Scottish Water's current information returns would be required. The quality regulators should also be informed about this change. **Action**

The Commission noted it would be helpful to clarify the specific meaning of the terms "outcomes", "outputs" and "objectives" in greater detail. A draft glossary of terms would be written for the Commission to consider. **Action**

The Commission noted that it would be important to define clearly the close of the Quality and Standards II period in order to effectively monitor the progress of Quality and Standards III. Two Commission papers would be written; one outlining how this could be done; and a second the actual closing position.

Action

Scottish Water's financial performance

The Chairman welcomed Dr John Simpson to the meeting to discuss the latest Resource Accounting and Budgeting (RAB) return from Scottish Water. This return was used to monitor Scottish Water's performance against previous years, against 2001 regulatory assumptions and against its second draft business plan projections. Analysis from this return supported the conclusion of the Capital Investment Return that the overhang from Quality and Standards II appeared to be growing.

It was noted that for future monitoring of financial performance it would be important to draw a clear line between the 2002-06 regulatory control period and the 2006-10 period. A paper for the Commission would be written setting out a methodology for how this could be done. **Action**

Funding development constraints of the water and waste water networks in Scotland

The Commission approved a public information note about the new reasonable cost regulations which would shortly be introduced by the Scottish Executive. This note would be placed on the Commission's website. **Action**

Development constraints issues

The Commission noted that Scottish Water had raised concerns about the extent of funding for the release of development constraints in the Final Determination. The Commission reiterated that sufficient funding had been allowed for Scottish Water to provide the strategic assets and make the

reasonable cost contributions necessary to release development constraints. It noted that according to the new reasonable cost regulations developers should fund the provision of non-strategic assets themselves (excepting the reasonable cost contribution Scottish Water is expected to make). It would be important that Scottish Water made this clear to developers and local authorities. A letter would be written to Scottish Water expressing this view.

Action

Scottish Water's Director's remuneration and incentive scheme

Dr Brooker noted that he had held a number of meetings with Scottish Water to discuss its preliminary proposals for a remuneration and incentive scheme for its Directors. He clarified that he had offered Scottish Water informal advice from the perspective of a non-executive Director. The Commission reiterated that the incentive scheme was a matter for Scottish Water and its owners to reach agreement on. However, the Commission recognised that it may be required to provide an objective view of outperformance in order for bonuses to be awarded. The Commission believed that it should be an underlying principle of any scheme that it is self-financing, that is, funded only from the proceeds of outperformance.

The Commission recognised that this raised the wider issue of how performance against the Final Determination could be monitored in a transparent way in the coming regulatory control period. The Commission agreed that a series of measures should be agreed that would monitor Scottish Water's performance against key targets in a publicly accessible way. This would include measuring financial performance using regulatory accounts, measuring customer service performance using the OPA and measuring the delivery of outputs in conjunction with the quality regulators and the HLMG. The Commission also noted the more specific issues of development, leakage and metering. A suite of measures would be developed and linked to measuring outperformance. **Action**

The Commission noted that measuring progress against the Final Determination target of Scottish Water achieving 50% of its Economic Level of Leakage (ELL) would require a detailed approach. The Commission agreed that it would be important for Scottish Water to set out how it intended to measure its ELL, and that this proposed approach would be reviewed by the Commission's engineering consultants. Scottish Water's performance would be measured against this agreed ELL. Scottish Water would be informed of the Commission's intentions. **Action**

Interim Determinations (IDoKs)

The Commission discussed the appropriate use of interim determinations in the coming review period. It agreed a publicly available information note should be written setting out the circumstances when an interim determination would be appropriate (in particular clarifying which circumstances would be deemed to be beyond management control) and the process that would be followed. **Action**

Trade effluent charging

The Commission reiterated its previously noted concerns about Scottish Water's proposed trade effluent charging, and particularly the principles underpinning the proposed method of charging. It agreed it would be important to seek initial views about trade effluent charging from a selection of stakeholders in a workshop, and then consult more widely on potential issues in June. **Action**

Response to licensing consultation

The Chairman welcomed Dr Jeremy Atkinson to the meeting to discuss the outcome of the Commission's December licensing consultation. The Commission noted that the consultation period had now closed and that all responses had been considered. A paper detailing the responses received to specific questions and the actions the Commission is minded to take would be placed on the Commission's website. **Action**

A second summary paper outlining the Commission's key conclusions would also be produced. This would detail the Commission's agreement that based on current submissions, Scottish Water's retail entity would not qualify for a permanent licence. However, there would be the option of awarding a provisional licence. The paper would note that the Commission is minded to receive applications for licences from January 2007. It would also clarify that at market opening, market mechanisms such as operational codes could not be expected to be definitive and would evolve with the market. **Action**

Retail licensing operational code

The Commission discussed the draft operational code submitted by Scottish Water on 21 December. The Commission were informed that the code had been subjected to two key tests; does it facilitate multilateral agreements? and does it avoid creating barriers to entry? The outcome of these tests suggested that a series of amendments should be made to the code. The Commission agreed a letter should be sent to Scottish Water outlining these issues and requesting a revised code be submitted. **Action**

Wholesale charging

The Commission considered a scoping paper for a proposed wholesale charging project. The Commission agreed the paper was appropriate, subject to a number of minor amendments. It also welcomed the opportunity for Scottish Water to participate in the project and agreed that it would be useful to regularly canvass the views of other interested parties. **Action**

Retail and wholesale split

The Commission were updated about two meetings that had been held with members of Scottish Water and Scottish Water business stream respectively. The former meeting had concentrated on separation issues, the latter specific retail issues.

The Commission noted that Scottish Water had two specific concerns about the Commission's guidance on the required degree of separation for the retail entity to achieve a permanent licence. The first related to the Chief Executive of Scottish Water's position as accountable officer of Scottish Water (and therefore the extent to which any accountability on his part would extend to Scottish Water business stream). The second related to a perceived lack of clarity about market mechanisms and how they would impact on the timetable of separation.

The Commission noted that a letter would be sent to the Scottish Executive to seek clarification about the responsibility of accountable officers. It also noted that Scottish Water had undertaken to produce a "strawman" of its view of how market mechanisms should function, and how this view would impact, if at all, on the timetable for separation. The Commission agreed a letter would be sent to Scottish Water to provide greater clarity about the criteria this "strawman" should meet. **Action**

The Chief Executive also noted that he would shortly be speaking to credit rating agencies regarding a suitable financiability test for potential licensees.

Scottish Water's delivery plan

The Commission were updated about a meeting held with Scottish Water regarding the resubmission of its delivery plan. At this meeting, Scottish Water had stated its understanding that the Commission would be required to approve the revised plan. The Commission noted that it had not yet been advised of this, but in the interim would be willing to provide Scottish Water with advice about whether its revised plan meets the objectives of the price determination.