

Stakeholder workshop 2: Scottish Water's revenue baseline and levels of service to customers

Why is Scottish Water's revenue baseline and how we measure levels of service important to customers?

It is important that when we set price caps, we understand the customer base of Scottish Water - how many customers Scottish Water has, what type of customers they are and what consumption characteristics they have. This includes understanding both the customer revenue base at the outset of the review period, and forecasts of how this base will change throughout the review period. This is because under a price cap setting system, the number, type and consumption characteristics of customers that Scottish Water has can significantly affect the revenue it receives, and in turn the prices customers pay. For instance:

- If Scottish Water's customer base is larger than we have assumed in the review, then it will collect more revenue than it needs. Price caps will have been higher than may have been necessary.
- If Scottish Water's customer base is smaller than we have assumed in the review, then it will collect less revenue than it needs. This means Scottish Water may not have sufficient funds to carry out its core functions.

The levels of service provided by Scottish Water are of obvious significance to customers. Customers should receive a level of service that is commensurate with the price they pay. During the price setting process, we make judgements about the level of efficiency that Scottish Water should operate at (compared with what has been achieved elsewhere). When we consider efficiency, we examine both the costs that Scottish Water incurs and the levels of service it provides.

Progress so far

In the run up to the 2006-10 price review, Scottish Water undertook a data cleansing exercise. As a result of this exercise, Scottish Water substantially reduced its non-household customer base. We accepted the revised information Scottish Water provided, despite concerns that Scottish Water appeared to have under-estimated its **initial customer base**.

In reaching our conclusions about Scottish Water's **future customer base**, we considered both the rate of underlying growth in connections and the investment that was being made available to release development constraints. We assumed that investment in releasing development constraints would displace approximately half of the historic rate of growth in connections.

At the 2006-10 Review, we had originally intended to adjust our benchmarking of Scottish Water's efficiency relative to that of the companies in England and Wales to take account of the poorer **level of service** provided to customers in Scotland. In the end we had to take another approach, which was to set separate **targets** for Scottish Water to reduce costs and to improve customer service. We assumed that levels of service improvements could be delivered by 2010 without significant additional operating costs.

We set Scottish Water levels of service targets by using Ofwat's **Overall Performance Assessment (OPA)**. The OPA assesses levels of service by taking measurements on a number

of different performance indicators and calculating an overall score. We used this score to make comparisons with the English and Welsh companies. This helped to inform our decision about the levels of service Scottish Water should aim to provide. We required Scottish Water to improve its OPA score by 40% over the four years of the regulatory control period. This will help to bring Scottish Water more into line with the English and Welsh companies.

At the 2006-10 price review, we recognised that mid-way through the regulatory control period, **retail competition** for non-household customers would be introduced. This would mean that Scottish Water would create a separate retail entity to serve non-household customers (now called Scottish Water Business Stream). In order to take account of this change, we calculated charge caps for household and non-household customers. We also calculated **indicative wholesale charges**. These are the charges that Scottish Water can charge Business Stream and other retailers for providing wholesale services to its customers.

Issues for the next review

There are two overriding issues that we will need to consider in this element of the methodology consultation. The first relates to the introduction of retail competition and how it will impact on the price review and the regulatory tools we use. The second is how do we provide Scottish Water with the correct incentives to continue to improve the levels of service it offers to customers?

We would welcome stakeholders' views on our overall proposed approach, and the specific issues set out below.

Issues in detail

Establishing a revenue baseline – The Central Market Agency (CMA) for the new retail market should provide accurate information about the number of non-household customers. We propose separately to identify the underlying level of expected growth and the impact of the release of development constraints.

OPA – impact of competition - The introduction of competition will impact on how we measure Scottish Water's levels of service. The OPA uses a series of measures which can be classed as "retail" activities. Scottish Water will no longer perform many of these activities for non-household customers.

OPA – using targets as regulatory incentives – regulation normally focuses on setting prices for the delivery of a specified outcome. If targets are set for both a reduction of costs and improvements in levels of service, it can make measurements of outperformance difficult. Rather than setting targets for levels of service at this review, is it reasonable to ask Scottish Water to indicate the costs that would be involved in improving levels of service? This information would be taken into account in our assessment of Scottish Water's operating cost efficiency.

Setting wholesale charge limits - The introduction of competition means that we will need to set wholesale charge limits. At the 2006-10 review we set indicative wholesale price limits by calculating the household and non-household revenue required by Scottish Water and its retail entity. We then deducted the appropriate level of retail costs. Should we take this approach again?