

Strategic Review of Charges 2010–14: Methodology

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

CONSULTATION

Overview

This document explains our proposed methodology in relation to customer revenue, levels of service & the new competition framework, and seeks stakeholders' views.

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How to respond to this consultation

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Please submit your response no later than **Friday 19 October 2007**.

We will publish all responses to this consultation unless respondents request otherwise.

Printed copies of this consultation are available from the address above.

Electronic versions are available on our website at www.watercommission.co.uk.

Background

Context

Every four years, we set limits on the prices that Scottish Water can charge customers for water and sewerage services. The next price review covers the period 1 April 2010 to 31 March 2014.

We issued a consultation document in December 2006, which set out our overall approach to the forthcoming review. We explained that we intended to carry out a further major consultation during 2007, which would cover the methodology we should use in coming to our decisions about price limits.

The December 2006 document explained that the methodology consultation would need to consider a number of components, and that these would be grouped into four volumes, as follows.

Methodology volume	Date volume is published
Volume 1: Financing & governance of Scottish Water	10 May 2007
Volume 2: Customer revenue, levels of service & the new competition framework	31 May 2007
Volume 3: Operating costs	28 June 2007
Volume 4: Capital expenditure	26 July 2007

This document is the second of the four methodology consultation documents.

Associated documents

- 'Our approach to the 2010-14 price review: A consultation', Water Industry Commission for Scotland, December 2006.
- 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

More detailed information about our proposed methodology in relation to customer revenue, levels of service & the new competition framework is available on our website: www.watercommission.co.uk

Introduction

In this volume, we outline our current thinking and seek stakeholders' views on the following questions:

1. What are respondents' views on our approach to establishing the revenue and customer baseline for the Strategic Review of Charges 2010-14?
2. What are respondents' views on our proposals to encourage Scottish Water to continue to improve the level of service it provides to customers?
3. How do respondents view the changes we are making to reflect the new competition framework?

The context in which these issues are being considered is determined by the Water Services etc. (Scotland) Act, which allows new water and sewerage retailers to obtain a licence to supply non-household customers from April 2008. It also requires Scottish Water to separate its 'retail' activities from its 'wholesale' operation. The separate retail entity would be licensed and would compete with new entrants on a level playing field. Scottish Water's retail function would no longer be a core activity and, as such, the Commission would be required to set the wholesale, rather than retail, charges that would apply to non-household customers.

Approach at the Strategic Review of Charges 2006–10

Customer revenue

Initial baseline

When we set price limits, we must pay particular regard to the initial customer base (that is, the number of customers in each category of customers). This is because the revenue actually raised from customers will differ from the amount of revenue we allowed for at the price review as a result of any changes in the number of customers or in their patterns of consumption.

In the months before the 2006–10 review, Scottish Water had substantially reduced its non-household customer base to take account of a 'data cleansing' exercise it had carried out. We broadly accepted the revised information Scottish Water provided to us, despite some concerns that it appeared to have underestimated its initial customer revenue base.

We suggested that Scottish Water should compare its network and billing databases and make sure that it was billing all those who received a service.

Forecast customer base

In reaching our conclusions about the 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 historical rate of growth in connections.

Levels of service

Guaranteed Minimum Standards (GMS) are the minimum standards of service that Scottish Water must meet, and which customers have a right to expect. Failure to comply with the standards entitles customers to financial compensation. The GMS do not cover every situation in which poor levels of service arise. For this reason we measure the level of service that Scottish Water provides to its customers using a version of the overall performance assessment (OPA), developed by Ofwat. This provides a more comprehensive picture of the level of service. Using the OPA measure, the level of service provided in Scotland improved by 24% between 2003 and 2006.

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. However, Scottish Water did not provide the information we required to do this, so it was not possible to assess the full scope for efficiency (including both reductions in costs and improvements in the levels of service). The Commission therefore decided to take another approach, which was to set targets for Scottish Water to reduce costs and a separate target for Scottish Water to improve its level of customer service. We required Scottish Water to improve its level of service – as

measured by the OPA – by some 40% by the end of the current regulatory control period. We set price limits in the final determination on this basis.

The introduction of a framework for competition

At the 2006-10 review, we outlined our approach to defining non-household wholesale and retail activities and their associated costs. We set price limits for each retail tariff basket. We calculated an appropriate level of wholesale revenue by identifying all non-household retail costs and subtracting them from the allowed for retail revenue.

We made adjustments for the higher cost of capital that the retail business faced and for additional transitional and market set-up costs. We did not allocate the allowed for wholesale revenue into tariff baskets.

Proposed approach at the Strategic Review of Charges 2010-14

Establishing a revenue baseline

Local authorities are responsible for billing household customers. They provide information to Scottish Water on the number of Band D equivalent properties that Scottish Water is serving. This Band D equivalent number takes account of the discounts provided to some households. We propose to ensure consistency between this information and Scottish Water's reported revenue from household customers.

The introduction of the new competition framework should reduce the level of uncertainty about the number of non-household customers supplied. Under the new arrangements, the Central Market Agency (CMA) will be responsible for maintaining an accurate record of non-household customers. We propose to use information supplied by the CMA in reaching our conclusions about the baseline for non-household customers. We also propose to introduce an incentive for Scottish Water to ensure that the CMA has a record of all of the properties it supplies.

We will separately identify both the underlying level of expected growth and the impact of the release of development constraints. This is likely to result in growth in the number of both household and non-household customers supplied. As in the Strategic Review of Charges 2006-10, we will ensure that our forecasts on customer numbers are fully consistent with the ministerial objectives on releasing development constraints.

Levels of service

Appropriateness of OPA targets: regulatory incentives and process

Economic regulation usually focuses on setting prices for the delivery of a specified minimum level of service to customers. If the regulator sets targets both for improvement in the level of service provided and for reduction in the level of costs incurred, there may be a need to determine the relative merit of a unit of service and a unit of cost. It is likely to be very difficult to measure the marginal impact of either a shortfall or outperformance against level of service targets.

Appropriateness of OPA targets: the impact of competition

The Water Services etc. (Scotland) Act introduced a licensing framework that allows non-household customers to choose a new retail supplier of water and sewerage services. The Act does not allow household customers a choice of supplier, but requires the Commission to ensure that the household customer is not disadvantaged.

We will have to adjust our use of the OPA to reflect the split between retail and wholesale activities. We do not believe that this will prove to be difficult. However, it may be appropriate

to require any new licensed retailers to deliver a defined level of service when they charge the default tariff¹.

Updating the OPA and improving consistency with Ofwat

There are three areas where we plan to improve consistency with the OPA as it is currently used by Ofwat. These are:

- pollution incidents,
- leakage targets, and
- assessed customer service.

There is a possibility that Ofwat may seek to revise the OPA to differentiate the level of service provided by the best companies.

The Commission proposes to focus on setting prices

We do not propose to continue to set both prices and targets for the level of service to be delivered. As noted earlier, it would become more complicated if we continued with this approach. At the 2010-14 review, we propose to ask Scottish Water to indicate the costs incurred in improving levels of service to customers. We propose to use this information to assess the scope for efficiency, consistent with Scottish Water matching, by 2014, the performance of leading companies south of the border in 2007-08. This approach also ensures that there would be no immediate impacts for us from any changes that Ofwat may decide to make to the OPA.

We would be interested in the views of stakeholders about the pace and extent of further improvement in levels of service that we should assume when setting prices.

Impact of the introduction of the competition framework on the Strategic Review of Charges

Setting price limits at wholesale for non-household customers

At the Strategic Review of Charges 2006-10 we set retail price limits and an indicative wholesale price limit. This was consistent with the Water Services etc. (Scotland) Act 2005 because Scottish Water had not then separated out its non-household retail activities.

In June 2007, we expect to approve the scheme of charges that would apply to the shadow market up to April 2008. Experience of introducing competition in other utility services suggests that there may be some changes to these initial wholesale charges. We propose to allow for such changes by creating wholesale tariff baskets only for water, waste water (including surface and highway drainage) and trade effluent. We will work with market participants to ensure that the tariff charges are broadly reflective of the costs that are incurred.

¹ In order to safeguard customers, it is our intention that all licensed providers will be obliged to offer the same default tariffs.

Later this year, Ministers will publish their proposals for the 'Principles of Charges'. We will set price limits that are consistent with these principles.

We do not propose to change significantly our approach to assessing the wholesale revenue that is required. We will again calculate the household and non-household revenue required by Scottish Water and its retail entity. We will then subtract the appropriate level of retail costs. We propose to use our assessment of the revenue that would have been required by a vertically integrated Scottish Water to set the level of default charges. In our view this approach remains valid because the market will not have opened up to competition before April 2008.

We propose to use 2007-08 as the base year for assessing the default tariffs that will apply during the 2010-14 regulatory control period. Each retailer will be required, by a licence condition, to offer the default tariffs to any non-household customer who requires a water and sewerage service.

We would be interested in the views of stakeholders about the level at which we should set default tariffs. Given that they are 'default' tariffs, there could be a strong argument in favour of allowing these tariffs to increase more quickly than would be implied by the level of revenue required from non-household customers. For example, we may not take account of the targets for efficiency included in the Strategic Review of Charges in setting the default tariffs. This approach could be an effective way of progressively removing price controls on the competitive market. If we were to adopt this approach we would expect retailers to have offered an alternative tariff arrangement to any non-household customers who, for whatever reason, were paying the default tariffs. Such a requirement could be made a licence condition.

Default level of service

The regulatory contract will apply only to Scottish Water's wholesale activities. We will expect new retailers to compete on both the price and the level of service provided. It would seem likely that competition for customers between retailers should lead to a general improvement in the value for money available to non-household customers.

The default tariffs will play an important role in ensuring that no customer could end up without a retailer. As a further safeguard, we intend to require each licence holder to sign up to a code of practice that will apply to all customers who pay the default tariffs. As such, each retailer will be required (under a licence condition) to provide a minimum basic service to any customer paying the default tariffs.

Departures from wholesale charges

In most cases, non-household customers are likely to find that a standard price and level of service offering from a licensed retailer meets their needs. However, Section 29E of the Water Services etc. (Scotland) Act 2005 also allows for a bespoke service to be provided where this is appropriate. If a customer has taken action to reduce the cost of supplying them with a water and sewerage service, this should be reflected in the wholesale charge levied by Scottish Water on that customer's retailer. The customer could still choose to

PROPOSED APPROACH: 2010-14

switch retail supplier, in which case their revised wholesale charge would be levied on the new retailer (provided that the reason for the original departure from the wholesale scheme of charges remained valid).

Scottish Water is not disadvantaged by these arrangements since they only apply when the actions of a retail customer have changed the level of costs it incurs. We plan to consult on our application of Section 29E later this year.

Next steps

The final date for responses to this consultation is **Friday 19 October 2007**. We encourage all interested parties to get in touch with us to express their views about our proposed approach.

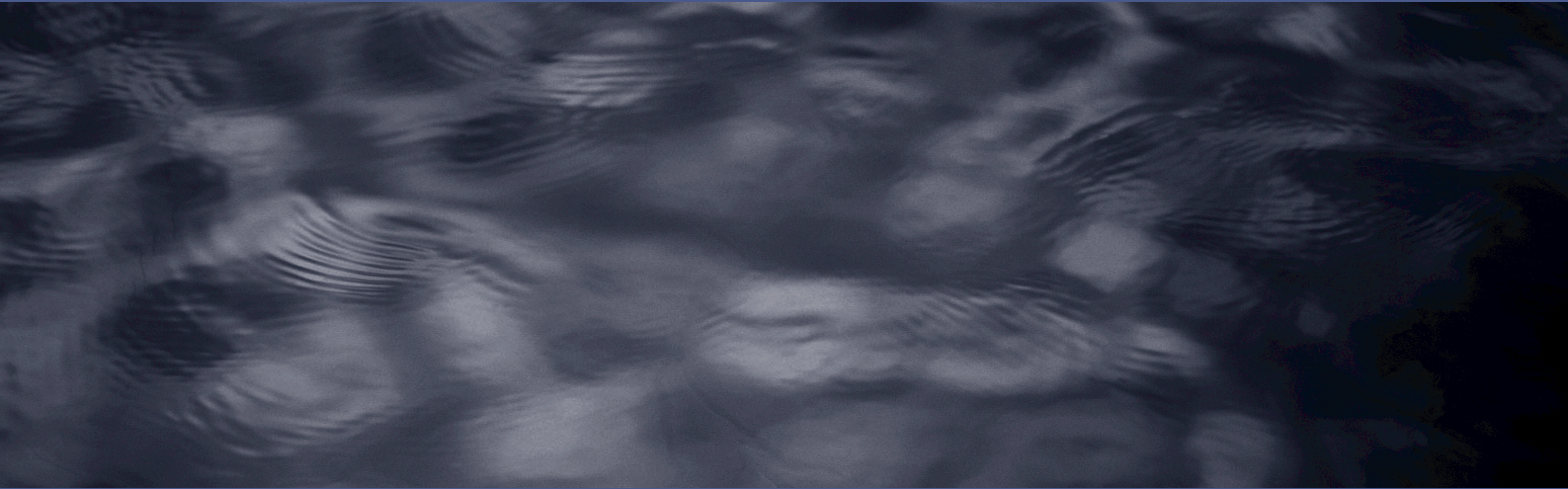
We will publish a response to the consultation findings on **Thursday 20 December 2007**. Please use this opportunity to take part in the debate.

NEXT STEPS

Questions for consultation

1. What are respondents' views on our approach to establishing the revenue and customer baseline for the Strategic Review of Charges 2010-14?
2. What are respondents' views on our proposals to encourage Scottish Water to continue to improve the level of service it provides to customers?
3. How do respondents view the changes we are making to reflect the new competition framework?

31.05.07



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