The Strategic Review of Charges 2010-14

The Draft Determination

water industry commission FOR SCOTLAND

Key messages

Our approach	• The Water Industry Commission for Scotland has a duty to promote the interests of water and sewerage customers. We limit the maximum level of charges that Scottish Water can levy on its customers.
	• This document explains the charges we propose to set for the period from 2010 to 2014 or 2015. We would welcome the views of stakeholders by 23 September 2009.
	• We will then publish our final decisions on 26 November 2009.
	• Our proposals:
	  ◦ take account of current economic uncertainty and pressure on public expenditure;
	  ◦ allow Scottish Water to cover its lowest reasonable overall cost of delivering the objectives of the Scottish Government within the Government's Principles of Charging;
	  ◦ do not compromise the prospect of stable charges for future generations.

Benefits for household customers in Scotland	• Our proposed charge caps would mean that all household bills rise annually by, on average, 1.5% less than the rate of inflation, but would enable Scottish Water to improve our environment; its public health compliance; and its customer service.
Benefits for non-household customers in Scotland	• Nearly all non-household customers would also see their bills rise by less than the rate of inflation. Some non-household customers may be able to negotiate even better prices. • Our approach to the setting of maximum retail tariffs should also make it easier for retailers to offer improved and more tailored levels of service to their customers. • We propose to begin to unwind the substantial cross subsidy that benefits some trade effluent customers to the detriment of all other non-household customers.

Benefits to the environment	• The draft determination would finance an investment programme of around £500 million a year (before inflation), allowing for the delivery of all of the Scottish Government's 'Priority 1' objectives, as well as:
	  ◦ addressing the pressing problems of Glasgow's drainage;
	  ◦ requiring a substantial reduction in Scottish Water's leakage to its proper economic and sustainable level; and
	  ◦ allowing for work with stakeholders in vulnerable water catchments and in others to reduce the risk of cryptosporidium.
	• We also propose to finance the first trial of household metering in Scotland.

Scottish Water's responsibilities and opportunities	• These price limits would allow Scottish Water sufficient finance to build on its achievements over the past seven years – particularly in the area of capital expenditure delivery. • If it achieves the efficiencies we expect, Scottish Water would end the regulatory control period in a strong financial position.
Governance and incentives	• The incentive and governance arrangements are critical to Scottish Water's success: in particular it should be able to borrow from the Scottish Government at a steady rate throughout the regulatory control period. • If such borrowing was not available, customers' charges would have to increase or Scottish Water's capital investment programme would need to be cut resulting in its level of service falling short of what could otherwise have been achieved.

Chairman's foreword

I have pleasure in publishing the Water Industry Commission for Scotland's Draft Determination of Charges for the regulatory control period 2010-14. This Draft Determination sets out the charges that we propose to allow Scottish Water to levy on its customers. It also explains our proposed changes to the maximum default tariffs that the new retailers can charge the businesses and public sector organisations of Scotland. I would be grateful if stakeholders would take the time to review our proposals and give us their views by 23 September. This will allow us to publish our final decisions on price limits on 26 November 2009.

I understand that the Scottish Government may be limited in the public expenditure that it can make available to Scottish Water and that it may no longer be able to offer Scottish Water the full flexibility in the timing of its borrowing that was available in the last regulatory control period. But Scottish Water must have flexibility to deliver the outcomes required within the regulatory control period. This degree of flexibility is an important factor in enabling Scottish Water to improve its efficiency – which is in the interests of both customers and the Scottish Government. If it is unable to make available the required level of borrowing, we believe the Scottish Government could consider using the Scottish Futures Trust as a vehicle for providing finance to Scottish Water or allowing Scottish Water to borrow commercially (along the lines agreed for Network Rail).

Scottish Water has continued this year to respond well to regulatory challenges. It is a real public sector success story. This Draft Determination challenges Scottish Water to build on its successes to date in further reducing its operating expenditure and further improving the level of service it provides to customers. The Commission recognizes that, over the last four years, Scottish Water has had to deliver a very large programme of capital expenditure. Our proposed charge caps allow for as large an investment programme as can be efficiently delivered and which would result in substantial improvements in our environment and in compliance with public health standards.

On behalf of the Commission, I would like to thank our staff very much for their hard work in providing the analytical support for our proposals.

Ian Byatt

Sir Ian Byatt
30 June 2009

Introduction

This Draft Determination is published at a time of significant economic uncertainty and covers a period of increasing pressure on public expenditure. We take account of these uncertainties in proposing charge caps and in our further steps to develop the governance and incentives framework within which Scottish Water operates. We considered all of the information available to us.

Our Draft Determination proposes charges that we believe represent value for money for customers. It would also enable Scottish Water to improve our environment; the level of service it provides to its customers; and its compliance with public health standards. Our proposed charge caps allow Scottish Water to cover its lowest reasonable overall cost of delivering the objectives of the Scottish Government. In proposing these charge caps we take full account of the Scottish Government's Principles of Charging.

The previous Scottish Government asked the Water Industry Commission for Scotland to set charge caps for a four-year regulatory control period from 2010 to 2014. We examined carefully the business plan submitted by Scottish Water and noted the concerns of the Scottish Environment Protection Agency (SEPA) that there should be no undue delay in making progress towards resolving the drainage issues facing Glasgow. We suggested to the current Scottish Government, Scottish Water, SEPA, the Drinking Water Quality Regulator (DWQR) and Waterwatch Scotland that it may be worth extending the 2010-14 regulatory control period by an additional year, such that it would end in 2015. The Scottish Government subsequently wrote to the Commission confirming that it would like to understand the implications for pricing and investment if the regulatory control period were to be extended to five years.

In our view, setting charges for a five-year regulatory control period could offer significant benefits to both customers and the environment. Customers would benefit from greater certainty in their bills. Scottish Water should be able to respond effectively to the results of the on-going studies of Glasgow's drainage and other areas where environmental improvements are essential. The extended regulatory control period would also make it easier for the Commission to monitor the performance of Scottish Water in delivering the Government's objectives and to hold it to account appropriately. We also believe that the extended regulatory control period should allow Scottish Water to improve further the efficiency with which it delivers the Government's objectives.

This Draft Determination of charges represents the culmination of a three-year process. We had input from many stakeholders, conducted detailed consultations on our methodology, and arranged workshops and stakeholder information days. We set out to operate a transparent process, in accordance with best practice. We would like to thank all those who contributed to the debate. We welcome the views of stakeholders on our draft conclusions. In particular we are keen to hear from both those who are disadvantaged by, and those who benefit from, the proposed unwinding of cross subsidies.

INTRODUCTION

In the interests of transparency we are publishing a set of staff papers which have been produced by our Office to assist stakeholders in responding to the Draft Determination. The staff papers have informed the preparation of our proposed conclusions, but do not form part of them. Accordingly, the staff papers should not be relied upon as expanding on, qualifying or replacing anything contained in the Draft Determination.

Printed copies of this Draft Determination and the staff papers are available from our Office. Electronic versions are also available on CD, and on our website at www.watercommission.co.uk. The financial and tariff basket models are also available on our website.

Scottish Water clearly demonstrates what a public sector organisation can achieve when it operates within a robust governance and incentives framework, including objective scrutiny and comment on its performance. It reduced its operating costs by almost 40% since its formation in 2002. It improved the level of service it provides to customers. It improved its compliance with public health and environmental standards and improved its responsiveness to developers.

As a direct consequence of this improvement, our Draft Determination offers the prospect of customers in Scotland continuing to see increases in charges below the rate of inflation: that is, no real increase in average prices. Charges in Scotland may increase less than in many areas of England and Wales over the next five years. At the same time, we expect Scottish Water to continue to improve its customer service and to achieve its economic level of leakage by the end of the regulatory control period.

The Commission recognises that the current regulatory framework can still be developed further. Our Draft Determination therefore clarifies the incentive and governance arrangements that we see as crucial to the effective operation of Scottish Water in the public sector. Our Draft Determination also considers carefully both the scope and timing of the delivery of capital expenditure. We believe that Scottish Water should build its understanding of its asset performance, and its management of the investment programme, to ensure that it can deliver the outcomes desired by stakeholders as efficiently as anywhere in the UK. This is likely to be more effective if the regulatory control period is extended to five years. Separately, we also allowed for the costs to Scottish Water of the introduction of revisions to its regulatory reporting requirements that will become necessary as a result of the separation of its non-household retail operations into a separate, arm's length, subsidiary company.

Scottish Water's ownership requires that, on an on-going basis, the Scottish Government commit substantial public expenditure to the water and sewerage industry in Scotland. This is because the Scottish Government is, at present, the only provider of capital; and Scottish Water is likely to need to borrow fresh capital each year in order to continue to invest in improving its assets. It is, of course, customers who cover the interest costs of any borrowing in their charges. For planning purposes we have had to plan on using £150 million and £140 million of public expenditure each year in the four and five year options respectively for the regulatory control period.

If Government were unable to make this public expenditure available, prices to customers would have to increase or delivery of the Scottish Government's objectives would have to be delayed or reduced in scope. Scottish Water may also have to pay higher corporation tax, which would further increase the bills of customers. The level of capital investment that the Government says that it wants to maintain (around £500 million per annum in real terms) would require a considerable increase in the level of borrowing available to Scottish Water at the start of the next regulatory control period.

Our proposed charge caps assume that Scottish Water borrows the same amount each year of the regulatory control period and allocates any unused resources to the gilts reserve in line with the process established for the 2006-10 Strategic Review of Charges.

Since we last determined charges in 2005, the Scottish water industry has undergone a radical change with the introduction of retail competition for all non-household customers across Scotland. In line with this important change, both scenarios for this Draft Determination include:

- proposed limits on the amount Scottish Water can charge households; and
- proposed limits on the amount Scottish Water can charge licensed retail suppliers in return for wholesale services.

We also propose the maximum increase in the default tariffs that retail suppliers must offer non-household customers under their licence conditions in the competitive market.

We followed the progress of the Cave and Walker reviews of the water industry in England and Wales very closely. The Cave review has confirmed our initial thoughts that we will need to develop further the Scottish regulatory framework. It is important that Scottish Water can demonstrate clearly its compliance with both UK and European competition law. Press commentary suggests that the Walker review is considering some of the environmental and customer benefits that may result from more extensive metering of households. We believe that similar benefits may apply to Scotland.

In our view, it is likely to be possible to design future household meter tariffs which create a financial incentive to save water and still protect vulnerable households. As such, there could be real environmental benefits from more extensive metering of households in Scotland. It may be beneficial to consider a metering trial or to begin to require new housing to be metered. In this Draft Determination we provisionally allow for the costs of a metering trial (estimated at £1 million a year for three years) and further work in this area. We will discuss with the Scottish Government, Scottish Water and Waterwatch Scotland how best to proceed.

Scottish Water costed its investment plans for 2010-14 at £2.0 billion including those projects that are yet to be delivered from previous regulatory control periods. It planned on spending a further £88 million in starting the delivery of the Government's objectives for 2010-14 in 2008-10 and £140 million in 2014-16 to complete the delivery of the Government's objectives. We made a number of adjustments to the capital expenditure proposals included in Scottish Water's second draft business plan. In our view, Scottish Water should require some £1.93 billion to deliver all of the Scottish Government's 'Priority 1' objectives efficiently.

However, we propose to allow for capital expenditure of £1.96 billion in 2007-08 prices if we are required to determine charges for a four-year regulatory control period. The additional capital expenditure allowed for recognises the pressing problems of Glasgow's drainage, and potential future obligations in respect of the Bathing Water Directive. Specific schemes will emerge from detailed studies and would individually be subject to a need being agreed with the Output Monitoring Group[1] (OMG) and the use of the Seven Stage Process[2].

In our five-year scenario we propose to allow Scottish Water the same amount for delivering the 'Priority 1' objectives. We recognise that addressing the required improvements to Glasgow's drainage will require a determined response from the industry, but also the certainty that the required financing is available. For the 2010-15 regulatory control period, we therefore propose to allow for an additional £245 million of enhancement capital expenditure and an additional year's allowance for capital maintenance. Again the allocation of enhancement capital expenditure will be subject to the approval of the OMG and the use of the Seven Stage Process. In both the four- and five-year scenarios, we propose to cap the average annual investment spend at approximately £500 million in 2007-08 prices. This is in line with the Scottish Government's objectives for the industry and independent advice provided to the Commission on the size of capital investment programme that can be efficiently delivered.

The proposed charge caps

We propose to set our charge caps relative to the Retail Prices Index (RPI) and, as such, we limit the real change in customers' bills. We propose retail charge caps for households. We also set out our proposals for the maximum increases allowed in the default retail tariffs that retailers can charge non-household customers. We also propose wholesale charge caps for Scottish Water that will limit the wholesale prices paid by the retail suppliers.

Our proposed charge caps mean that all household customers can look forward to increases in their bills below the rate of inflation. We consider that it is important to emphasise that we do not propose to achieve this price stability at the expense of future customers. Scottish Water would end the regulatory control period in a strong financial position – if it meets the terms of its regulatory contract.

We are proposing these charge caps in uncertain times. It is possible that retail price inflation may remain very low, particularly in the early part of this next regulatory control period. Should such a situation develop, it may be appropriate for Scottish Water's scheme of charges to freeze the nominal level of some charges and reduce future nominal increases[3]. This could help ensure that customer charges stay as stable as possible.

[1] The Output Monitoring Group comprises representatives of the Scottish Government, Scottish Water, SEPA, DWQR, Waterwatch Scotland and the Water Industry Commission for Scotland. It meets quarterly to review Scottish Water's progress in delivering the Government's objectives.

[2] The Seven Stage Process is set out in detail on our website at www.watercommission.co.uk

[3] Such a freeze would be maintained until any upward movement was neutral in its impact on customers on a net present value basis. The discount to be used would be the adjusted weighted average cost of capital (WACC) of 4.1% proposed in this Draft Determination.

Table 1: Charge caps for household customers

	Each year of the regulatory control period
Household unmeasured water	RPI minus 2.2%
Household unmeasured waste water	RPI minus 0.9%
Average	RPI minus 1.5%

Table 2: Maximum increases to default tariffs levied by licensed retail suppliers

	Each year of the regulatory control period
Water	RPI minus 2.2%
Waste water	RPI minus 0.9%
Trade effluent	RPI plus 1%

Governance and incentives

We consider that Scottish Water must have flexibility to deliver the outcomes required in the next regulatory control period. Such flexibility is likely to be important to the improvement in efficiency that is in the interests of both customers and the Scottish Government.
We understand that the Scottish Government may now no longer be able to offer Scottish Water the full flexibility in the timing of its borrowing that was available in the last regulatory control period. We take account of this in proposing charge caps.

The Scottish Government plans to allow Scottish Water to borrow up to £150 million in each year. Our proposed charge caps assume that Scottish Water borrows £150 million each year of a four-year review period and £140 million each year of a five-year review period.
We further assume that Scottish Water transfers any unused resources available to it during the financial year to its reserve account. This account would serve in part as a shock absorber between the necessary multi-year planning horizon of Scottish Water and the shorter term public expenditure framework. It would also serve as a contingency, which could, subject to the agreement of the Commission, be available to Scottish Water to cover costs outside the control of management that may otherwise have led to an interim determination.

Consequently, it is particularly important that the gilts reserve account be maintained and managed as originally agreed for the current regulatory control period. Any surplus in this account should not be regarded as outperformance until we complete our assessment of Scottish Water's performance. This can happen no earlier than the late summer of the year in which this regulatory contract ends. The resources in the reserve account should only be used by Scottish Water to meet the costs of timing differences whether these be variances in the outcome delivery profile included in the review of charges or in the profile of efficiencies achieved. All stakeholders should look at the resources available to Scottish Water in both borrowing from the Scottish Government and customers' charges over the entire regulatory control period. A significant surplus in any one year does not mean that these resources will not be needed, nor does a small or nil balance in the gilts reserve account necessarily mean that Scottish Water is performing poorly.

Our proposed charge caps assume use of the full amount of borrowing that the Scottish Government has been able to allocate to the water industry[4]. This level of borrowing is lower in both nominal and real terms than that which was available to the industry in previous regulatory control periods. Previously, we have not required the full amount of borrowing that the Scottish Government was prepared to make available, but we now consider that any further reduction in real terms of the level of borrowing available could lead to customers' bills being higher than is necessary. This is for two reasons – firstly customers would be paying a higher proportion of capital expenditure from current revenue than is desirable or consistent with the underlying risk of the industry, and, second, the financing of capital expenditure from retained earnings results in the Scottish water industry making unnecessarily high corporation tax payments. In 2014-15 or 2015-16 (the first year of the next regulatory control period), Scottish Water may require access to borrowing of the order of £170 million-£200 million in nominal terms – an amount that may increase by up to 5% each year if the Scottish Government continues to set environmental and social objectives that would require the industry to invest around £500 million a year in real terms.

We recognise that the Scottish Government may face increasing pressures on its available budget. If the Scottish Government is unable to make the required level of borrowing available in this regulatory control period or the larger sums that will be needed in the future, it could consider using the Scottish Futures Trust as a vehicle for providing finance to Scottish Water or, if possible, allowing Scottish Water to borrow commercially along the lines agreed for Network Rail. In this regard, we note recent HM Treasury Budgeting guidance[5] that suggests PPPs should be accounted for under UK GAAP[6] (ie off balance sheet) and recent press commentary that PPP contracts may remain off balance sheet even under the new International Financial Reporting Standards.

How we have set charges

We allow Scottish Water a level of revenue that covers all of its operating, capital and financing costs, taking account of the level of borrowing that is made available by the Scottish Government.

Allowed for rate of return

At the end of the current regulatory control period, we ensured that Scottish Water should enjoy a robust financial position if, of course, it meets the challenges set out in this Draft Determination. Our review of the financial strength of the companies south of the border would suggest that Scottish Water's financial strength should, at the end of this regulatory

[4] Slightly less under our proposed five-year regulatory control period.

[5] http://www.hm-treasury.gov.uk/d/consolidated_budgeting_guidance200910.pdf

[6] Generally accepted accounting principles.

control period, be on a par with the stronger companies. We consider that the most important indicator of Scottish Water's financial strength is retained cash flow (RCF) to outstanding debt[7].

In proposing charge caps, we allowed for an average post-tax real rate of return on Scottish Water's regulatory capital value of 2.7%. At the current time Scottish Water's level of depreciation is higher than that which Ofwat would finance in companies' price limits. If we adjust for the level of Scottish Water's depreciation to this lower level and add this reduction to the allowed for cost of capital, then the effective actual rate of return that we have allowed Scottish Water increases to 4.1%[8]. This is the rate of return that we believe Scottish Water should use in calculating contributions to developers. Given that Scottish Water does not pay a dividend, this allowed for rate of return is broadly consistent with that allowed for in other regulated infrastructure industries[9].

In proposing charges we allowed for a real cost of debt of 3.5%. Any difference between this allowed for cost and the actual cost faced by Scottish Water should be credited to the Scottish Water reserve account. Our allowed for cost of debt has meant that no special allowance for Scottish Water's embedded debt is necessary. This allowed for cost of debt should ensure that, in the event that the Scottish Government is unable to make the necessary level of public expenditure available, the Scottish Futures Trust would likely be able to make the necessary debt finance available on a commercial basis. There need be no adverse impact on customers as a result.

Table 3: Comparative financial strength of Scottish Water with the companies in England and Wales

Company	RCF:Debt five-year ratio 2003-04 to 2007-08
Thames Water	12.1%
United Utilities	10.3%
Severn Trent Water	7.5%
Northumbrian Water	7.4%
Dŵr Cymru	7.4%
Wessex Water	7.1%
Yorkshire Water	5.0%
Southern Water	4.8%
South West Water	4.2%
Anglian Water	3.0%
Scottish Water 2010-14 review period	**12.6%**
Scottish Water 2010-15 review period	**12.4%**

[7] This ratio is defined as net cash flow from operating activities less tax paid less net interest paid less customer rebate, all divided by net debt.

[8] This rate of return is presented in a manner fully consistent with regulatory practice south of the border. It is broadly consistent with the ex-post cost of capital of Glas Cymru.

[9] In our view, given the likely limits on further borrowing, we believe that Scottish Water should use an implied real cost of equity of 6.0% in its cost/benefit analyses.

KEY ASSUMPTIONS

Key assumptions in this Draft Determination

The chargeable customer base

There is still evidence that not all of the non-household customers receiving a water and sewerage service are being billed. As such, it is possible that Scottish Water should be earning more revenue (at the current level of tariffs) from its existing customers. We propose to introduce an incentive for retailers to identify such customers. This would be based on an approach similar to that used for the calculation of the reasonable contribution towards initial infrastructure costs incurred by developers of new properties that is already made by Scottish Water. We also propose to establish a small incentive for retailers to identify properties currently registered as 'void' (and hence not chargeable) but where there is now an occupant in receipt of a service. We will consult on the implementation of these proposals after our Final Determination.

We have seen no evidence that there are household customers receiving a service and not being billed.

Growth

In proposing charge caps, we make assumptions about the customer base that we expect Scottish Water to serve. We make separate estimates for household and non-household customers. In making projections, we take account of historical trend changes in the customer base and Scottish Water's projections of growth in its investment plans. Given the current economic climate, we believe it prudent to make assumptions about growth that are at the lower end of recently observed trends.

For household customers, we assumed an annual growth rate of 0.7% per year, which is around a third lower than recent historical trends.

Table 4: Increase in Band D equivalent households (water) in the Draft Determination

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Number of Band D equivalents (thousands)	1,942	1,955	1,969	1,983	1,997	2,011
Percentage change in Band D equivalents		+0.7%	+0.7%	+0.7%	+0.7%	+0.7%

The non-household customer base is impacted by changes in the overall number of customers, as well as changes in the mix and type of services taken by these customers. In its second draft business plan, Scottish Water assumed that there would be a fall in the customer base in the next few years, before returning to modest growth in 2012-13. We consider that this is a reasonable assumption and adopted it in proposing charge caps.

KEY ASSUMPTIONS

Table 5: Change in non-household customer base (water) in the Draft Determination

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Total number of meters	120,838	120,779	121,526	122,197	122,776	123,133
Total volume (Ml)	155,482	155,691	156,254	156,770	157,260	157,675
Impact of above on Scottish Water's customer base		-1.0%	-0.6%	+0.4%	+0.4%	+0.4%

Our assumptions for waste water household and non-household customers are set out in the following two tables.

Table 6: Increase in Band D equivalent households (waste water) in the Draft Determination

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Number of Band D equivalents (thousands)	1,846	1,859	1,872	1,885	1,898	1,912
Percentage change in Band D equivalents		+0.7%	+0.7%	+0.7%	+0.7%	+0.7%

Table 7: Change in non-household customer base (waste water) in the Draft Determination

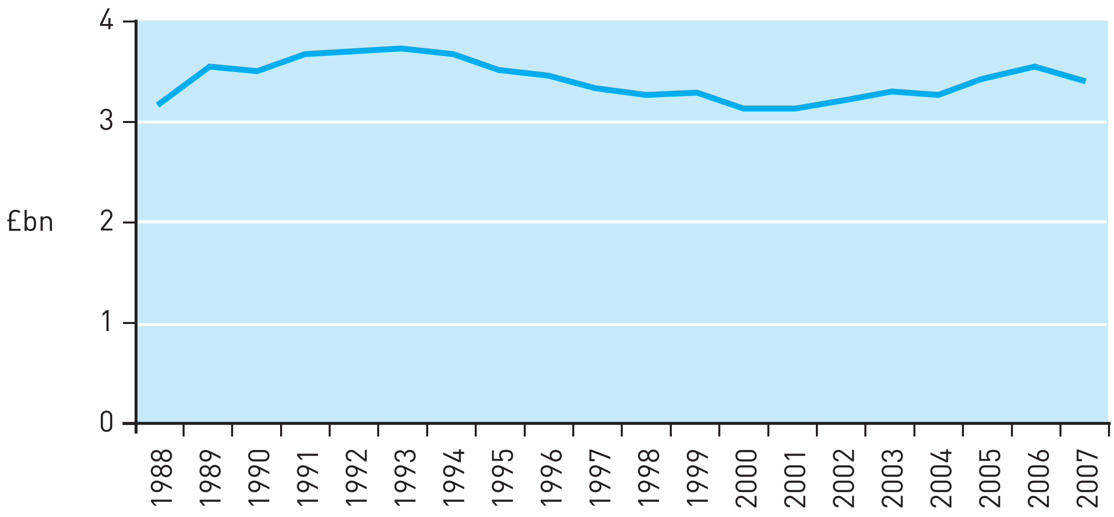
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Total number of meters	95,549	95,489	96,262	96,953	97,546	97,910
Total volume (Ml)	54,118	54,183	54,357	54,516	54,668	54,796
Surface and highway drainage rateable value (£ million)	2,807	2,806	2,813	2,819	2,825	2,828
Trade effluent (connected premises)	1,493	1,493	1,493	1,493	1,493	1,493
Impact of above on Scottish Water's customer base		-0.4%	-0.5%	+0.3%	+0.3%	+0.3%

Allowed for operating costs

We based our expectation of the level of operating costs that Scottish Water should require on the history of operating expenditure in the water industry. Our review of the performance of the companies south of the border strongly suggests that they are consistently able, over a series of successive price reviews, to deliver broadly constant real operating expenditure. This is summarised in Figure 1.

KEY ASSUMPTIONS

Figure 1: Operating expenditure in England and Wales (2007-08 prices)



In our view, Scottish Water should be able to operate its business and meet any new obligations with operating expenditure that only rises in line with inflation each year. This applies to our proposed charge caps for both four and five years. Indeed, given the recent track-record of the Scottish Water management team, we believe that, with its previously demonstrated determination and commitment, Scottish Water could outperform this assumption.

We assessed this level of annual operating expenditure to be £280 million in 2007-08 prices, based on the level of operating expenditure that Scottish Water incurred in 2007-08. We included an additional allowance of around £10 million:

- we included an allowance of £2.5 million annually to improve regulatory reporting;
- we added an allowance of £2 million annually to work with stakeholders in five water catchment areas that may be resource constrained or where more pro-active work with local landowners is required; and
- we included £1 million annually to facilitate Section 29E departures and improve Scottish Water's Strategic Asset Capacity Development Plan.

In addition:

- we allowed for the operating costs of controlling odour at waste water treatment works (£1 million a year);
- we allowed for Scottish Water's contribution to the Central Market Agency's costs (£1 million a year); and
- we included £0.5 million annually for the cost to Scottish Water of facilitating retail competition.

Furthermore,

- we allowed for the costs of the proposed household metering trial (£1 million a year for three years).

Finally,

- we made an allowance of £1 million a year for the additional costs of working to reduce the risk of cryptosporidium in five catchments to be agreed with the DWQR.

Benchmarking

In order to check our assumption of constant real operating expenditure, we compared Scottish Water's operating expenditure with that incurred by the water and sewerage companies in England and Wales. To do this, we used the econometric models with which Ofwat compares the performance of the companies in England and Wales, adapting these to include information from Scottish Water. We required Scottish Water to match the current performance of upper quartile companies in England and Wales in terms of efficiency by 2013-14. In the event that we set charges for five years, we would expect operating costs in 2014-15 to remain the same as in 2013-14 in real terms.

We took full account of the information contained in Scottish Water's second draft business plan. However, in a number of areas, we adjusted the assumptions used in Scottish Water's plan. We did this only where we considered the evidence to be weak or insufficiently objective.

Our benchmarking analysis suggests that, given determined management, Scottish Water could outperform our allowance of constant real operating expenditure by up to 5% by 2013-14. This would be consistent with recent upper quartile company performance. If Scottish Water were to improve its efficiency at a steady pace towards this level, it could generate outperformance savings of around £20 million to £30 million over the regulatory control period for the benefit of customers.

We also used our alternative WICS model and this broadly supports the results of our use of the adapted Ofwat econometric models.

Levels of service performance

We consider that the overall performance assessment (OPA) is the most effective measure of performance that is currently available. We are pleased that Scottish Water now embraces the OPA and we welcome the progress made. Our proposal to require Scottish Water to reach upper quartile performance by 2013-14 was widely accepted by stakeholders in their responses to our methodology consultation and indeed by Scottish Water in its business plan. We will therefore expect Scottish Water to achieve an OPA score of 389 by the end of the 2010-14 regulatory control period. If we determine charges for a five-year period, the OPA target would increase to 400.

In setting our allowed for level of operating costs for Scottish Water, it is important to emphasise that we allowed for Scottish Water to have sufficient resources to meet this level of performance. Scottish Water stated that the performance of Dalmuir waste water treatment works (operated under a PPP concession) may be problematic. We believe that Scottish Water should manage performance risks determinedly – even when it is not directly responsible for the operation of an asset. In our view Scottish Water should be ultimately responsible for the performance of the assets even if they have been procured and are operated under the provisions of a PPP type of arrangement.

WHOLESALE CHARGE CAPS

PPP

We made the same assumption on operating expenditure remaining constant in real terms in relation to the PPP charges that Scottish Water incurs. We assumed this to be £130 million per year – this is actually slightly higher than the level that Scottish Water forecasts it will incur at the end of this regulatory control period. However, we also allowed £2 million a year to be used by Scottish Water to ensure that the PPP contracts meet current environmental standards and customers' expectations.

Wholesale charge caps

Unwinding cross subsidies

We propose caps on the wholesale charges that Scottish Water levies on licensed providers. These allow for the unwinding of identified cross subsidies both between household and non-household customers and also between the different types of services provided to non-household customers. The Draft Determination proposes to begin to unwind the substantial cross subsidy that has benefited some trade effluent customers to the detriment of all other non-household customers. We propose to consult further with stakeholders on how these cross subsidies should be unwound at the retail level.

Unwinding trade effluent cross subsidies will require changes to the 'default' tariffs within the overall charge cap. Our consultation will focus on the setting of these individual 'default' retail tariffs for trade effluent. The Commission wants the transition to broadly cost-reflective tariffs for trade effluent to be as smooth as possible. In particular, customers should not face unnecessary reductions followed by larger than required increases in their trade effluent bills.

Transferring activities to licensed providers

In this Draft Determination, we also propose to finance the transfer of some activities from Scottish Water to licensed providers. These cover:

- metering services;
- trade effluent sampling and consent monitoring; and
- new connections.

Our estimate of Scottish Water's cost of providing these services is around £8 million per year and we propose to reduce Scottish Water's wholesale charges to reflect this. We are consulting separately on the detailed changes to the operating code that we need to make to reflect these developments.

Resulting wholesale charge caps

Our proposed wholesale charge caps are set out in Tables 8 and 9. We propose to transfer responsibility for the new activities to licensed providers from the start of the regulatory control period. This requires a bigger adjustment to wholesale charge caps in the first year.

Table 8: Wholesale charge caps – year 1

	Year 1 of regulatory period
Water	RPI minus 8.1%
Foul sewerage and surface drainage	RPI minus 9.1%
Trade effluent	RPI minus 6.8%

Table 9: Wholesale charge caps

	Years 2–4 or 5 of regulatory period
Water	RPI minus 4.1%
Foul sewerage and surface drainage	RPI minus 7.3%
Trade effluent	RPI plus 1%

Impact of charge caps on the competitive retail market

Since April 2008, the water and sewerage bills that non-households in Scotland pay have been influenced by two main factors:

- the wholesale price that Scottish Water charges licensed providers; and
- any deals that customers have been able to negotiate with licensed providers for services that they receive.

Licensed providers are already offering improved services relating to water efficiency and waste management advice to non-household customers. This benefits both customers and the environment. From April 2010, we plan to increase the range of services that licensed providers can offer to customers to include tailored metering services, trade effluent consent management and new connections. This should allow licensed providers to meet the needs of their customers more effectively and to continue to promote environmental benefits.

Licensed providers' revenue is determined by the difference between the wholesale charges that they pay to Scottish Water and the retail bills issued to customers. At the current time, in order to protect non-household customers, we set 'default' tariffs that limit prices that can be charged by licensed providers where they do not offer any additional services. Initially, these were set broadly at the level that Scottish Water would have charged had retail competition not been introduced. We propose in this Draft Determination that these 'default' tariffs should now change in line with charges to household customers.[10]

The difference between default charges and wholesale charges impacts the margin available for licensed providers to serve business customers. In the 2006-10 period, we assessed this margin to be around 11%, based on the costs that Scottish Water incurred in providing its limited retail service before the introduction of competition. The charge caps proposed in this Draft Determination will allow this margin to increase.

In our view it is important that retailers are able to offer more tailored levels of service to their customers and more value added services such as advice on water efficiency and on

[10] Except for trade effluent, which will be the subject of a separate consultation.

reducing a customer's impact on the environment. In proposing 'default' tariffs that change in line with household charges, we expect to see initiatives from the licensed providers in these areas. We would also expect to see customers who would not benefit from such value added services to be offered supply arrangements at prices lower than the 'default' level.

Incidence of the industry's costs

Economic regulation has always looked at the costs a company is about to incur and allowed it to raise an appropriate level of revenue from its customers. In particular, water regulation recognised that the RPI-x formulation had to be adapted to consider the substantial investment in environmental and public health improvements. As such, RPI-x became RPI-x+q, q being the impact of these necessary improvements on customers' charges.

The RCV of Scottish Water, given the level of depreciation that has been allowed for in customers' charges, is largely accounted for by the assets that have been built or improved to respond to the need for higher standards of public health and environmental compliance. These are primarily assets relating to water resources and treatment and waste water treatment and discharge. It is important that our understanding of the costs of a water and sewerage company and the remuneration of the asset owner are, and are seen to be, consistent. For example, this understanding is critical to an assessment of the true economic and sustainable level of leakage. We would expect that the value of water and waste water treatment assets would similarly dominate the current RCVs of the companies south of the border, especially given that the levels of compliance required are broadly similar.

In this regard we note the conclusions of the Competition Appeal Tribunal in the *Albion Water* Case that it had found it difficult to gain a proper understanding of the true costs of supply. Following the Cave report on competition in the water industry, there is likely to be an increasing focus on whether water companies' operations are fully consistent with UK and European competition law. In our view the traditional cost allocations in the water industry, which appear to focus on sunk costs, could leave the industry open to accusations of margin squeeze[11]. This would not be in the interests of customers, even if it did not have any immediate effect on the prices that end customers would pay.

In our methodology paper (December 2007) we outlined our plans to begin to improve our understanding of the incidence of costs within the water industry. Our preliminary results are outlined below. We calculated indicative cost allocations based on information from Scottish Water on its costs in 2007-08. These cost allocations are for Scottish Water's wholesale business only, excluding its costs associated with retailing to household customers.
We removed household retail costs and concluded that overall wholesale costs were around £912 million in 2007-08.

Table 10 shows how our review of forward-looking sustainable costs applies to various areas of Scottish Water's wholesale business. We welcome comments on these allocations.

[11] Margin squeeze exists where a company pays itself more for a service than it is prepared to pay a potential alternative provider of the same service.

Table 10: Indicative cost allocations in Scottish Water's wholesale business (2007-08)

	Water treatment	Waste water treatment	Water network	Waste water network	Total
Operating expenditure	£60m	£64m	£65m	£42m	**£232m**
PPP charges	-	£124m	-	-	**£124m**
Maintenance charges	£100m	£78m	£72m	£57m	**£307m**
Cost of capital	£143m	£91m	£9m	£7m	**£250m**
Total	£303m	£357m	£146m	£106m	**£912m**
Percentage of total	33%	39%	16%	12%	**100%**
Percentage of total (treatment/networks)	**72%**		**28%**		**100%**

This analysis shows that the principal activity of water and sewerage companies is the management, design and delivery of water and sewage treatment assets and their operation. And this is fully consistent with how the owners of water businesses earn their return: by investment in improving their asset bases (principally in treatment) and not from their ownership of the legacy network.

At this stage we made a simplifying assumption that the return on capital would be the same for each area. We are planning more work in this area and will report on our conclusions in our Final Determination. We estimated the current cost of capital based on the difference between total costs and the operating and maintenance costs. We allocated this cost of capital primarily to the treatment businesses to reflect the substantial levels of enhancement investment that has still to be paid for. We assumed that the pipe network is, effectively, already bought and paid for and is maintained in perpetuity through a renewals charge. In our view, a return should only be earned on any enhancements to the network. We based our initial estimate of the return on capital required by the networks business on an assumption that it may need to finance up to two years of network enhancement in advance of receiving payment.

Investment programme

Scottish Government's objectives for 2010-14

The Scottish Government has set draft objectives,[12] which cover:

- levels of service to customers,
- provision for new development,
- improvements to drinking water quality,
- ensuring adequate water resources,
- environmental performance,
- alleviation of flooding,
- climate change and adaptation, and
- odour reduction.

These objectives have been categorised by the Scottish Government as 'Priority 1', the highest priority and 'Priority 2', a lower priority. The Scottish Government recognises that objectives listed as Priority 2 are in fact needed but can, in the view of stakeholders, be deferred into a subsequent investment period. We were requested to determine the extent to which Priority 2 objectives can be delivered efficiently and without projected charges to customers in the period to 2014 rising by more than the level of inflation.

Our review of the 'Priority 2' objectives suggested that they are subject to a much greater degree of uncertainty than the 'Priority 1' objectives. In general these objectives would need much greater definition before we should consider financing them. However, this does exclude some of the proposed studies included in the 'Priority 2' objectives, which we believe could be important to ensuring the efficient and effective delivery of investment in the next regulatory control period. We are also persuaded by the views expressed by SEPA that addressing Glasgow's drainage should be a priority and that progress could be hampered if resources were not available. It could also include studies of how Scottish Water could best adapt to and mitigate the potential threat of climate change. Our proposed charge caps allow for as yet undefined investment that can be allocated if and when these needs or, indeed, other priorities are better understood. In our scenario for a four-year regulatory control period, we allowed for £25 million of as yet undefined enhancement investment. In our five-year scenario, we allowed for £245 million. Our approach to capital maintenance is outlined below.

Our alternative five-year profile takes account of Scottish Water's planned delivery of the Scottish Government's objectives beyond the end of the four-year period. Scottish Water indicated that completion of projects such as the work required in Glasgow to address flooding issues and unsatisfactory discharges will require investment beyond 31 March 2014. SEPA rightly wants to ensure that Scottish Water delivers all of its responsibilities in improving Glasgow's drainage in the most efficient and timely way. We consider it likely that additional investment (beyond that currently suggested by Scottish Water) may prove to be

[12] The draft objectives are available at http://www.scotland.gov.uk/Topics/Business-Industry/waterindustryscot/DSMO

necessary in the period until 2015. Our proposed charge caps for five years allow for the maximum potential level of investment that could be efficiently delivered.

We are keen to allow Scottish Water some flexibility in how the capital expenditure necessary to meet the Government's objectives is delivered. However, we also have to be reassured that the customer is not paying too much for a promised level of service that can only reasonably be delivered some time after the customer has begun to pay. We will monitor carefully Scottish Water's performance in delivering outputs, confirmed, as appropriate, by SEPA, DWQR, or the Scottish Government.

We considered carefully how the resources allocated to as yet undefined enhancement investment in areas such as Glasgow's drainage and the Bathing Water Directive should be managed in order that the interests of the customer are appropriately protected. We concluded that, in the four-year scenario, all of the additional investment should have been defined as detailed schemes arising from modelling studies (and agreed by OMG) by 30 June 2011. In the event that it is not specified fully or is not required the Commission will seek to implement an interim determination of charge caps. In the absence of any additional relevant factors, this would further reduce the level of bills faced by customers. It could also reduce the industry's need for public expenditure.

In the five-year scenario, we would require that at least £125 million had been defined and agreed by 30 June 2011 and that the remainder of £120 million, giving a total not exceeding £245 million, be specified and agreed no later than 30 June 2012. In the event that these resources were not considered necessary or could not be spent efficiently, the Commission would seek to complete an interim determination.

Scottish Water's view of investment required to deliver the Scottish Government's objectives

Scottish Water's second draft business plan set out its view of the investment required to deliver the Scottish Government's objectives. Scottish Water stated that it would need to invest £2.2 billion in total to meet the Scottish Government's 'Priority 1' objectives including an overhang of £169 million from the previous period. Scottish Water's proposals include an 'early start' programme and an element of investment completion after March 2014. Scottish Water indicated that it sees this as necessary to provide continuity of investment planning and delivery across regulatory control periods.

Scottish Water's plan sets out proposals to spend just under £2 billion during the 2010-14 period, around £500 million per annum. Scottish Water's proposed investment is split 45%/55% between capital maintenance (investment to maintain the existing asset base) and capital enhancement (investment providing improved levels of service). Scottish Water's proposed investment on the key elements of the programme is set out in Table 11.

INVESTMENT PROGRAMME

Table 11: Scottish Water's proposed investment by category (post-efficiency)

	Scottish Water identified investment £m
Priority 1 objectives plus Scottish Water identified priorities	
Maintaining serviceability	928
Environment	445
Drinking water quality & resources	388
Growth	177
Flooding Bill	14
Seafield treatment works (odour)	16
Reducing inadequate water pressure	7
Sub-total	**1,975**
Other investment	
Overhang from previous period	169
Early start for next period	74
Total	**2,218**
Investment proposed out-with the 2010-14 period	228
Total investment proposed in the 2010-14 period	**1,990**

Our view on the level of investment required to deliver the Scottish Government's objectives

In reaching our conclusions on the resources required to deliver the Scottish Government's 'Priority 1' objectives we considered carefully Scottish Water's submissions, the analysis of the Reporter and the views of other stakeholders. We also had regard to the following factors, which were set out in our methodology document[13]:

Deliverability: we took account of the research completed by LECG of the factors to be considered in assessing the deliverability of the programme. We also took into account lessons learnt from Scottish Water's performance in delivering the current (2006-10) £2.4 billion investment programme.

Definition: working with both SEPA and the DWQR, we ensured that sufficient definition of outputs is available to allow Scottish Water's performance to be properly monitored and assessed. In those areas where we identified that there is insufficient clarity on requirements we proposed that studies are carried out before investment is committed.

Ensuring effective delivery: the Reporter carried out a detailed review of Scottish Water's proposals including assessing the scope of requirements, the technical solutions proposed and the basis of cost estimates and their consistency with Scottish Water's cost base. We reviewed the Reporter's comments and carried out additional analysis to assess whether Scottish Water's proposals meet the Scottish Government's objectives in the most effective way possible.

[13] Strategic Review of Charges 2010-14: Methodology, Volume 4: Approach to capital expenditure, July 2007, available at www.watercommission.co.uk

Assessing the scope for efficiency: we used benchmarking techniques, originally developed by Ofwat, to assess the scope for efficiency in Scottish Water's procurement. As part of this assessment, we reviewed and took account of special factors identified by Scottish Water, which impact on their costs. We believe there is scope for greater efficiency in all areas of the programme.

The outcome of our assessment for each investment category is set out below.

Capital maintenance

Capital maintenance investment underpins existing levels of service to customers. In our view, there is little evidence to suggest that a large increase in the historic level of capital maintenance investment is required to maintain the serviceability of assets to customers. There is evidence of scope for more effective delivery, which should result in improved performance relative to the current regulatory control period. We also believe that Scottish Water has further progress to make in improving its knowledge of its asset base, which will result in improved targeting of investment.

Scottish Water proposed capital maintenance investment of £928 million (post-efficiency) for the 2010-14 period. We assessed Scottish Water's capital maintenance proposal in detail, and took account of the views of the independent industry Reporter, SEPA and the DWQR. We concluded that an allowance of £880 million for four years or £220 million per annum (post-efficiency) was sufficient.

For our proposed extension of the regulatory control period to five years, we allowed for a further £220 million of capital maintenance.

We used four high level analysis techniques to confirm the adequacy of the proposed capital maintenance allowance. The results were within a range of approximately 92% to 99.5% of our allowance.

Drinking water quality

Scottish Water proposed investment (pre-efficiency) of £475 million on drinking water quality improvements, including £29 million on tackling levels of lead in drinking water, £151 million on protecting drinking water from the risk of cryptosporidium, £128 million on a major programme of water pipe rehabilitation to reduce levels of iron and manganese and some £73 million on improved water resources. We discussed Scottish Water's proposals with the DWQR and/or SEPA as part of our assessment of the scope of Scottish Water's proposed works.

Our assessment indicated that the scope of works proposed by Scottish Water for tackling cryptosporidium at water treatment works could be provided at lower cost without impairing Scottish Water's ability to achieve the standards defined by the DWQR. We therefore reduced allowable costs in this area by 25% (pre-efficiency) for delivery of the proposed solutions but proposed an additional £2 million of investment on studies to examine the true extent of cryptosporidium risk across Scotland and to identify sustainable and cost-effective solutions in the remaining catchments. We further include £1 million annually for the operation of five further projects to work with stakeholders in lower risk catchments to eliminate the risk of cryptosporidium. These areas should be agreed with the DWQR.

We also believe that Scottish Water's proposed costs in some other areas of the drinking water quality programme are too high and we therefore made reductions in allowed for costs. These include the allowances for treating raw water supplies, increased disinfection control, providing emergency tanker filler points, fitting devices to prevent backflow into the drinking water network, carrying out studies of the requirement for lead pipe replacement and replacing lead service pipes at the customer's request. It should be emphasised that the outputs to be delivered in all of these areas remain the same. We reduced the allowance sought by Scottish Water by a total of £14.2 million in these areas.

Scottish Water proposed investment for an upgrade to a treatment works, which is impacted by a voluntary arrangement between Scottish Water and landowners in the catchment supplying the treatment works. We believe that Scottish Water should be encouraged vigorously to pursue the continuation of this type of voluntary arrangement as the least cost and most sustainable way of achieving the required outputs. Should Scottish Water be unable to secure continuation of this voluntary arrangement then Scottish Water could turn to the OMG for the release of some of the resources allocated to unspecified investment. We therefore removed this allowance for investment but we include an additional allowance of £2 million of operating costs for developing sustainable solutions of this type in this and four other catchments. These catchments should be agreed with SEPA and/or DWQR as appropriate. This approach is consistent with some of the more innovative solutions to catchment management being implemented south of the border. The total reduction in allowed for costs in this area is £10.4 million.

Our assessment of Scottish Water's proposed investment in water mains refurbishment has taken account of the overlap of this work with activities in the capital maintenance programme. We concluded that proposed investment for cleaning (termed 'flushing and swabbing') of the network should form part of the capital maintenance programme. Similarly, we disallowed investment requested in this category for carrying out further network investigations on the basis that this should either form part of the capital maintenance programme or, more likely, be covered by on-going operational expenditure.

Scottish Water requested an allowance for significant investment for improving the security of supply in 15 water resource zones. We believe that further investigation is required to determine the true extent of needs in these water resource zones and to ensure that full account has been taken of the opportunities for addressing any supply deficit through leakage control and demand management opportunities. We propose finance for study work to be carried out during the regulatory control period and a lower allowance for addressing any necessary interventions identified through these studies. This lower allowance will be subject to the Seven Stage Process to ensure that the proposed solutions meet the regulators' requirements and are value for money. These adjustments reduced the resources allowed for from those requested by Scottish Water by £21.5 million.

Overall, our review of Scottish Water's proposals for water quality improvement reduced Scottish Water's allowed for planned spending (pre-efficiency) by £113.9 million. As a result, we allowed for £361.0 million (pre-efficiency) in our draft charge caps to meet the Scottish Government's objectives for improving water quality.

Environmental improvement

Scottish Water's second draft business plan proposes total investment to deliver the Scottish Government's objectives for improving our environment of £473 million (pre-efficiency). It includes investment of £258.7 million for Unsatisfactory Intermittent Discharges (UIDs), £244 million of which relates to schemes in Glasgow. Our discussions with SEPA confirm that there remains considerable uncertainty around the work required in Glasgow and we agree with Scottish Water's proposal that detailed study work is required to determine the true extent of work required. This is consistent with the approach being adopted for the River Clyde strategic study.

We reviewed Scottish Water's proposals carefully and concluded that the allowance for the UIDs should be reduced to reflect an average unit cost for the programme consistent with Scottish Water's historic costs. We further reduced the allowance to reflect the scope to reduce requirements through a pro-active approach to tackling infiltration[14]. Our approach allows work to commence when the study work is complete, and approval has been obtained from SEPA and the Commission. We agree that the use of a process similar to the Seven Stage Process adopted during the current regulatory control period is appropriate for the UID programme. We reduced the allowed for amount compared with that requested by Scottish Water by £50 million (pre-efficiency).

We recognise that there is a legal obligation on Government to meet the shellfish water standard at Loch Ryan. However, we challenged Scottish Water's proposals. We are not convinced that there is sufficient evidence either that this project will deliver the required environmental benefits or that it is consistent with Scottish Water's duty to have regard to sustainable development. We believe that further study work is required on the solution at Loch Ryan before customers' money is committed. We therefore added £1 million for additional study work to confirm that the proposals are consistent with Scottish Water's duties on sustainable development, including taking account of the likely price of carbon, the risk that the required shellfish water standard may still not be met even if the investment is made, and the level of disruption (both to the environment and to the local community) caused by the proposed works.

We allowed for the likely cost of the proposed improvement, but this allowed for investment at Loch Ryan is ring-fenced until such time as this study work is complete and has been published; at which time final agreement can be reached with stakeholders on the proposed solution. This additional £1 million allowance results in no overall change to the allowance claimed by Scottish Water as we reduced the allowance for the waste water treatment works programme by £1 million to account for some minor over-scoping identified by the Reporter.

Our assessment of Scottish Water's environment proposals also highlighted some over-scoping of requirements in other areas and we made associated reductions in the allowed for

[14] Infiltration is water that finds its way into the sewer system from the ground or surface and reduces sewer capacity.

investment for flow monitoring and study work. We reduced the allowance sought by Scottish Water in these areas by £3.6 million (pre-efficiency).

We noted that Scottish Water had made separate 'risk allowance' provisions throughout the programme and particularly on items in the environmental programme. Based on our assessment of the Reporter's comments on Scottish Water's costing systems we believe that the level of on-costs applied to projects already includes a significant element of risk provision and no further allowance should be required. We have, therefore, not allowed these additional provisions for risk.

Our review of Scottish Water's environment proposals reduced the allowance for Scottish Water's planned spending (pre-efficiency) by £66.2 million. As a result, we allowed for £406.7 million (pre-efficiency) in our draft charge caps to meet the Scottish Government's objectives for improving the quality of our environment.

Growth

Scottish Water proposed investment of £190 million (pre-efficiency) on meeting the demand for new connections to the water and sewerage network. This includes £105 million for new strategic network capacity, an estimated £62 million for 'reasonable cost' contributions to those providing new connections and £24 million to cover the impact of new connections on the existing sewer network.

Scottish Water's assessment of the investment required to meet demand for strategic network capacity has been made at a time when future development forecasts for both commercial and domestic property are very uncertain. In recognition of this fact, Scottish Water proposed that this area of investment should be 'ring fenced' to allow increases or decreases in investment requirements above or below forecast to be accommodated.

We believe that adequate regulatory mechanisms exist, through the allocation of the unspecified investment, the 'logging' process or the potential for an interim determination, to accommodate changes in the required level of strategic capacity. We are therefore not minded to 'ring fence' investment in this area.

We are also not persuaded by Scottish Water's claim for specific investment to increase sewer capacity to prevent increases in sewer flooding due to growth. The removal of internal sewer flooding is addressed elsewhere in the programme and we are concerned that there are no clear outputs for this proposed investment. We believe that concerns over the impact of new development of this type could be addressed through the use of 'Section 29E' opportunities for reducing costs. We therefore removed this allowance but provided an allowance for facilitating 'Section 29E' opportunities in this and other areas.

Our review of Scottish Water's growth proposals reduced our allowance for Scottish Water's planned spending (pre-efficiency) by £13.8 million. As a result, we allowed for £176.6 million (pre-efficiency) in our draft charge caps to meet the Scottish Government's objectives for responding to the demand for new connections to the water and sewerage system.

Other investment priorities

Scottish Water proposed further investment to address additional priorities that it identified for the 2010-14 period. This includes investment to improve the level of odour control at Seafield waste water treatment works along with investment to address the likely implications of the proposed Flood Risk Management Bill and to reduce the incidence of low water pressure.

We previously allowed for resources in the PPP allowance for improvements in odour control at the PPP works at Seafield. We therefore removed this amount from our allowance for PPP but allowed for the proposed direct investment in this area for odour improvement at Seafield. In so doing, we assumed that Scottish Water has taken account of and addressed the risks associated with the resulting confusion of asset ownership and management responsibilities on a PPP site.

We accepted Scottish Water's proposals for investment to address the likely implications of the Flood Risk Management Bill but we will seek to establish clear outputs in this area. This investment will be subject to the Seven Stage Process.

Scottish Water's proposals for investment to reduce the incidence of low water pressure are not included in the Scottish Government's objectives but would appear to provide value for money for customers. We therefore allowed for this investment.

Profile of investment between regulatory control periods

We favour stability in the level of investment undertaken by the industry. This should help Scottish Water to deliver the Government's objectives efficiently. It should also be good for contractors who should see a more predictable flow of work and resulting reductions in their costs of maintaining capacity, which should benefit customers in lower prices from contractors. As such, we broadly support the proposals for an 'early start' to enhancement projects as it ensures continuity of investment between regulatory control periods and ensures that customers are receiving the benefits of investment earlier. We support 'early start' notwithstanding the risk that it could delay some projects financed in previous periods, which, of course, would not be in the interests of customers.

However, just under half of Scottish Water's early start claim for both the 2010-14 and 2014-18 periods appears to comprise early investment in 'capital maintenance' projects associated with maintaining existing levels of service to customers. Capital maintenance is carried out on a 'rolling' basis where many projects can be planned well in advance of work being carried out. We are therefore not persuaded that early start capital maintenance expenditure is appropriate and we disallowed this expenditure.

We were concerned by the proposed completion of the delivery of the Government's objectives for the current period after 2014. The proposed 'late finish' primarily comprises investment in the currently uncertain UID programme in Glasgow and for completion of the mains renewal programme. Although Scottish Water did not seek the financing of the work beyond 2014, the customer would, de facto, have underwritten the costs of this work. We do not consider that this was in the interests of customers. As a result our four-year charge caps include allowance for the costs of all the work (in order to avoid the risk of later cost escalation at the expense of the customer).

We believe that our proposal to extend the current regulatory control period to five years can resolve this issue more effectively.

Investment to develop the regulatory framework

We are currently discussing with Scottish Water proposals to develop the regulatory framework in Scotland. This development is necessary because of the separation of non-household retail activities required by the Water Services etc. (Scotland) Act 2005.

This would include the accounting separation of the water network and water treatment functions and the same separation on the waste water side. As discussed earlier, costs should be allocated such that Scottish Water is not vulnerable to allegations of margin squeeze. Ensuring that Scottish Water complies fully with the UK and European competition framework will substantially reduce the risks faced by Scottish Water. These measures may involve one-off costs to Scottish Water's wholesale business, for example to develop IT infrastructure and systems. We allowed for investment of £15 million (pre-efficiency) to develop the regulatory framework.

Treatment of uncompleted projects from previous investment periods

Scottish Water indicated that a number of projects from previous investment periods will not be completed by the start of the next regulatory control period. This means that expected benefits for customers from the previous investment programmes, for which they have already paid, will be delayed.

We accepted Scottish Water's estimate of the cost of completing the remaining projects. Customers should be assured that they will not pay any more as a result of these delays. Any increase in costs resulting from capital expenditure inflation will have to be absorbed by Scottish Water through greater efficiency. We will also take these extra costs into account when assessing the efficiency with which earlier phases of the investment programme have been delivered.

The scope for efficiency

We assessed the scope for capital efficiency in both the capital maintenance and capital enhancement programmes. This capital efficiency assessment is carried out at a programme level: we do not seek to review the relative efficiency of individual projects.

We used Ofwat's 'cost base' approach to benchmark Scottish Water's efficiency in delivering capital projects. This approach uses a series of 'standard costs' supplied by water companies to compare relative procurement efficiency. In this assessment, we also take account of special factors relating to the industry in Scotland.

A review of Scottish Water's cost base submission was carried out by Jacobs plc who, along with the Reporter, confirmed the validity of Scottish Water's costs for use in the cost base approach.

Overall we assessed the scope for capital expenditure efficiency by using the capital efficiency factors that resulted from this analysis. We assumed upper quartile performance by Scottish Water by the end of the regulatory control period, consistent with our challenge to Scottish Water in other areas.

Summary of our allowed for investment

Table 12 sets out the components of our overall assessment of the allowed for investment for the four-year and five-year regulatory control periods.

Table 12: Summary of allowed for investment[15]

	Scottish Water's claim for four years	Commission's adjustment: four-year review	Commission's adjustment: five-year review	Our allowed for investment 2010-14	Our allowed for investment 2010-15
Drinking water quality	£474.9m	-£113.9m	-£113.9m	£361.0m	£361.0m
Environmental improvement	£472.9m	-£66.2m	-£66.2m	£406.7m	£406.7m
Growth	£190.4m	-£13.8m	-£13.8m	£176.6m	£176.6m
Other investment priorities	£39.9m	-£0.9m	-£0.9m	£38.9m	£38.9m
Strengthening the regulatory framework	£0.0m	+£15.0m	+£15.0m	£15.0m	£15.0m
Total pre-efficiency enhancement investment	£1,178.0m	-£179.8m	-£179.8m	£998.2m	£998.2m
Efficiency challenge on enhancement	-£130.4m	-£20.9m	-£24.2m	-£151.3m	-£154.6m
Total post-efficiency enhancement investment	**£1,047.6m**	**-£200.7m**	**-£203.9m**	**£846.9m**	**£843.7m**
Capital maintenance	£927.8m	-£47.8m	+£172.2m	£880.0m	£1,100.0m
Total post-efficiency base investment	**£1,975.4m**	**-£248.5m**	**-£31.7m**	**£1,726.9m**	**£1,943.7m**
Completion of previous investment programmes	£169.0m	£0.0m	£0.0m	£169.0m	£169.0m
'Early start' investment for next regulatory control period	£74.0m	-£35.4m	-£35.4m	£38.6m	£38.6m
Additional outputs to be specified by OMG	£0.0m	+£25.0m	+£245.0m	£25.0m	£245.0m
Total new investment	**£2,218.4m**	**-£258.9m**	**+£177.9m**	**£1,959.5m**	**£2,396.3m**
Total investment per annum	£554.6m	-£64.7m	-£75.3m	£489.9m	£479.3m

[15] Numbers may not add up due to rounding.

Leakage

We recognise that Scottish Water has made a start in incorporating leakage into its organisational strategy and addressing the unacceptable level of leakage that existed in 2006. In our view reducing leakage is not just economically justifiable – reducing operating costs and capital expenditure – but will also contribute to Scottish Water delivering its obligations with regard to sustainable development, and reducing its carbon emissions.

We are keen to see Scottish Water improve its understanding of leakage and its costs at a local level and for it to take local action where appropriate. But we are also keen to ensure that Scottish Water's leakage strategy is fully aligned with its asset maintenance and enhancement planning. We are concerned that leakage performance is not yet fully integrated into the strategy of the organisation.

More work is still required, but our current view is that it could be reasonable for Scottish Water to reduce its current level of leakage of approximately 800 Ml/day to something well under 500 Ml/day by the end of the regulatory control period.

Conclusion

We believe that our Draft Determination would be good for customers; good for our environment in Scotland; and good for the Scottish economy in this time of great uncertainty. It would also allow Scottish Water to build on what it has achieved over the past seven years. Scottish Water's effective response to the challenges that it has been set by its regulators is a credit to its Board, its management and all its employees. It is, without any doubt, a public sector success story.

But that performance, no matter how excellent, is now a matter for history. We expect Scottish Water to build on that success and demonstrate that it can maintain and improve further the service it provides to its customers. Scottish Water should use this extra time to ensure that its capital expenditure delivery matches the performance it has achieved in delivering improved levels of service and in reducing its operating costs.

Good for Scottish households

Our Draft Determination offers the prospect of charges rising by less than inflation for all household customers. In proposing these charges we have not compromised the prospects for future charges, nor have we cut any corners with the delivery of all of the Scottish Government's objectives for the industry. In this time of economic uncertainty, it is important that customers can look forward to water and sewerage charges that will not increase by more than the rate of retail price inflation for up to the next five years.

Looking forward beyond this regulatory control period, if Scottish Water continues to improve its efficiency and if Government is able to make the required levels of borrowing available, customers in Scotland can continue to look forward to bills that need not increase above the rate of inflation.

Good for businesses and the public sector in Scotland

Our approach to the business and public sector retail 'default' tariffs should make it easier for retailers to offer improved and more tailored levels of service to their customers. Almost all non-household customers should see their bills fall in real terms and the level of service improve substantially. For those for whom value added services are less important, the reductions in bills could be more substantial.

Some trade effluent customers would see increases in their trade effluent bills as the cross subsidy that has existed in their favour is gradually unwound. Reductions in their water, waste water and drainage bills could offset these increases at least in part. But there would still be others who will see reductions in their bills for trade effluent.

Good for our environment in Scotland

Our Draft Determination allows for many potential improvements to our environment in Scotland beyond those that are outlined in the objectives of the Scottish Government.
We propose to require a further substantial reduction in Scottish Water's leakage to its proper economic and sustainable level. We allowed for resources for Scottish Water to work with stakeholders in water catchments that may be resource constrained or where more

pro-active work with local landowners is required; and in further catchments which may be vulnerable to cryptosporidium. We also propose to finance the first trial of household metering in Scotland.

Our proposed five-year regulatory control period could also be important to Scottish Water's ability to respond in a timely fashion to the important studies that are already underway and to respond effectively to SEPA's concerns about the Glasgow drainage system.

Good for our economy in Scotland

Both the Scottish and the UK Governments have said that they see spending on improving our infrastructure as important to reducing the impact of the current recession. Any such spending should be efficient and properly targeted. In this regard, we should emphasise that this Draft Determination finances an annual investment programme of approximately £200 for every connected property in Scotland. It will average around £500 million each year (before inflation). Our analysis suggests that this is as large a programme as can be efficiently and timeously delivered. The capital investment programme, therefore, provides certainty to the construction industry in Scotland.

Good for sustainable development in Scotland

Sustainable development requires that we pay proper regard to economic, environmental and social factors. Our Draft Determination proposes that charges remain as affordable as possible, that we gather evidence on whether household metering could bring environmental benefits and an appropriate degree of social protection, and that we continue to invest in improving our economy through facilitating new connections and improving public health and the environment. In particular our Draft Determination seeks to encourage Scottish Water to find alternative approaches to improving the service it provides to all of its customers and to adopt civil engineering solutions only when they offer demonstrable and sustainable advantage.

Our Draft Determination would achieve all of these benefits whilst not disadvantaging future generations of customers. Scottish Water would remain in a strong financial position if it meets the challenges set out in this Draft Determination. Subject to Government being able to make the necessary borrowing available, customers can look forward to bills that do not increase above the rate of inflation.

We believe that the charges proposed in our Draft Determination should allow Scottish Water to deliver the Scottish Government's objectives at the lowest reasonable overall cost. In so doing we challenge Scottish Water to build on its successes of its first seven years.
We believe that it can continue to rise to this challenge and underline its status as a public sector success story.

CONCLUSION

This Draft Determination has benefitted from the input of many stakeholders. We are grateful for their input. We welcome comments from stakeholders on our draft conclusions.
In particular we are keen to hear from those who are disadvantaged by and those who benefit from the proposed unwinding of cross subsidies. Please send your views to:

Katherine Russell
Director of Corporate Affairs
The Water Industry Commission for Scotland
Ochil House
Springkerse Business Park
Stirling
FK7 7XE
Email: draftrepresentation@watercommission.co.uk
Fax: 01786 462018

We should receive representations on or before 23 September 2009. We will publish all responses to this consultation unless respondents request otherwise.

Printed copies of this Draft Determination and of the staff papers are available from our Office. Electronic versions are also available on CD, and on our website at www.watercommission.co.uk.

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Water Industry Commission for Scotland
Ochil House, Springkerse Business Park, Stirling FK7 7XE.
T 01786 430200 **F** 01786 462018 **E** enquiries@watercommission.co.uk
www.watercommission.co.uk

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