

## Policy for Section 29E

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This document sets out the Commission's current policy in relation to section 29E<sup>1</sup>. There are four sections:

1. The first section details the legal background and the principles;
2. The second section deals with pre-application issues;
3. The third section sets out the mechanics of making an application including the matters to be taken into account and criteria to be applied in making each section 29E determination; and
4. The fourth section sets out the step by step process the Commission will follow for each application.

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<sup>1</sup> Section 29E of the Water Industry (Scotland) Act 2002 (**the Act**) as inserted by section 21 of the Water Services etc. (Scotland) Act 2005.

## Section 1

### *Principles*

- In the Commission's view it is a good thing that customers should seek to reduce their costs to be served. The Commission is in favour of efficiency as it is in the interest of all customers; efficiency may manifest itself in lower costs immediately or by creating capacity in the system which will reduce average unit costs in a given area.
- The Commission is also in favour of customers having choice when purchasing services, even if those services increase system costs, provided customers pay a price which is reflective of the increased costs of delivering that level of service.

### *The legal position*

- Section 29E of the Act allows Scottish Water to apply to the Commission for its consent to depart from a charges scheme in respect of charges to be paid by a water services or sewerage services provider (**the licensed provider(s)**).
- The Commission has taken advice from a leading QC on the implementation of section 29E and, specifically, how any claimed increase or decrease in Scottish Water's costs/revenues will be determined.
- Under section 29E(2)(a) of the Act, for each section 29E application to reduce the charges from a charges scheme the relevant licensed provider must explain what its customer has done, or agreed to, and how that will lead to a reduction in Scottish Water's costs in providing services to it (for example, if it allows Scottish Water to connect a new customer at no cost and reduces average unit costs in a given area).
- Likewise, for each section 29E application to increase the charges from a charges scheme, Scottish Water must explain what the relevant licensed provider's customer has done, or agreed to, and how it will lead to an increase in Scottish Water's costs in providing services to it.
- It is important to note that there is no requirement under section 29E to demonstrate that costs borne by other customers will be reduced or increased by the actions, or the agreement, of the relevant licensed provider's customer, although the Commission may take such cost reductions or increases into account in determining a section 29E application.

## Section 2

### *Initial proposal by licensed provider*

Although a licensed provider may approach Scottish Water informally for initial discussions on possible section 29E departures, the formal obligations listed below commence once the licensed provider submits a formal proposal to Scottish Water.

The formal proposal should set out details of:

- Licensed provider applying;
- Location of proposed activity;
- Nature of proposed activity;
- Source of savings;
- Amount of savings; and
- Time period over which savings would be realised.

This proposal does not have to be as detailed as an application to the Commission would be, but should be enough to convey a good understanding of what is proposed.

### *Scottish Water's costs*

Scottish Water may incur costs by investigating and processing the application. Because the Strategic Review of Charges 2006-10 covers all Scottish Water's costs in meeting its statutory obligations, including section 29E, Scottish Water may not seek to recover these costs from applicant licensed providers.

As such, no application fee may be charged and the costs of processing the application cannot be subtracted from the calculation of savings that Scottish Water realises from the section 29E departure. However, the share of benefits received by Scottish Water should substantially outweigh any initial up-front costs.

### *Confidentiality*

Discussions between Scottish Water and a licensed provider on a potential or actual application for a section 29E departure are confidential. Neither party may divulge details to other customers or market participants.

## Section 3

### *Scottish Water applies to the Commission for the section 29E departure*

Under the Act, although a licensed provider must explain what its customer has done, or agreed to, and how that will lead to a reduction/increase in Scottish Water's costs, only Scottish Water can make an application for section 29E departure.

To ensure the process is not delayed unnecessarily, Scottish Water must pass through any application automatically or provide the Commission with written justification of its refusal to do so<sup>2</sup>.

Scottish Water must make this application within 3 months of receiving the formal proposal from the licensed provider. The application must follow the form published by the Commission. If Scottish Water believes it needs more time to make the application, it must justify the extension to the licensed provider. The licensed provider may complete an application at any time (in accordance with the form published by the Commission) and direct Scottish Water to pass the application to the Commission.

When Scottish Water submits an application to the Commission, the licensed provider should include its own comments on the proposal. For example, it may indicate:

- That it agrees with all of the contents; or
- That it disagrees with particular aspects, for example whether the scheme is practicable, the amount of savings or the estimate of the costs Scottish Water incurred in processing the application.

On the other hand, if the licensed provider completes an application and compels Scottish Water to pass the application to the Commission, Scottish Water may attach comments to the application. However, Scottish Water cannot delay the application in doing so.

We hope that Scottish Water and the licensed provider will agree the details in most cases. This includes the calculations of Scottish Water's savings associated with the departure. Although the Commission would not be bound to agree to all of the details of a section 29E application, the fact that the parties agreed would carry weight.

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<sup>2</sup> Scottish Water is required to comply with this requirement under paragraph 11A of the Water Services (Codes and Services) Directions 2007.

## *Calculation of a departure from the wholesale charge*

The Commission expects that the savings from the section 29E departure will be shared between Scottish Water and the licensed provider in proportions to be decided.

The parties may suggest the appropriate reduction in the application: this may be expressed as an absolute figure or as a percentage discount from the standard wholesale charge.

## *Matters to be taken into account and criteria to be applied*

- The Commission will exclude decisions on location as the basis for section 29E applications in line with Scottish Ministers' stated policy of geographical harmonisation of Scottish Water's charges. However, actions taken prior to the commencement of the Act will be an acceptable basis for an application.
- In assessing any viable section 29E application, all costs and benefits will be assessed on a net present value (NPV) basis.
- Any reduction or increase in costs claimed must be a net reduction or increase in the NPV of the overall costs of serving the particular customer. For example, if a customer has taken action or made an agreement that reduces one category of costs, but causes a greater increase in costs in other categories which outweigh those reductions, there will be no grounds for a departure. Likewise, there will be grounds for a departure if a customer causes an increase in costs for certain other customers, provided that there is a net reduction in the NPV of overall costs.
- The discount rate that will be applied in assessing the NPV will be an indicative real pre-tax weighted average cost of capital (WACC) of 2.4%. The period of time for assessing the NPV will be the life of the project which forms the basis of the section 29E application.
- For each section 29E application, the Commission's assessment of the costs and benefits that accrue to Scottish Water will take account of genuinely stranded assets.
- The Commission will define when it considers an asset stranded, for example, they may be stranded when there is little or no possibility of an asset being used again, or when the owner is prepared to write it off.
- Scottish Water will be required to publicise where it has significantly under utilised assets as this may assist customers and licensed providers in identifying section 29E opportunities.

## *Increases to Scottish Water's wholesale charge*

The 2005 Act allows for Scottish Water to apply for a departure from the wholesale charges scheme where a customer of a licensed provider has done, or agreed to, something that increases Scottish Water's costs. It is possible that Scottish Water will apply for such departures, either with or without the support of the relevant licensed provider. It is also possible that a licensed provider might initiate such an application when it is seeking an enhancement to Scottish Water's normal service.

Where a licensed provider initiates a section 29E application to increase Scottish Water's wholesale charge, the process above will apply (with references to savings and charge reductions modified appropriately).

Where Scottish Water initiates a section 29E application to increase its wholesale charge, it must inform the licensed provider at least three months before submitting the application. Scottish Water must also give the licensed provider a draft application at least one month before submitting it to the Commission. The licensed provider may attach its own comments to the application on any aspect.

## Section 4

### *The process for determining section 29E applications*

There will be a timetable for the Commission accepting section 29E applications, and new departures from the charges scheme will take effect on either 1 April or 1 October in each year.

#### **Stage 1: Acknowledge receipt of application**

Within 10 working days of receiving an application from Scottish Water we will open a case and acknowledge receipt. We will issue a unique reference number and provide contact details for further queries regarding the case.

#### **Stage 2: Assess jurisdiction and viability**

Having opened a case and acknowledged receipt, we will scrutinise the application to identify whether we have jurisdiction to deal with it under the relevant legislation. If necessary, we may need to obtain further information in order to make that assessment. If we conclude that we do not have jurisdiction to deal with the matter, we will close the case and advise Scottish Water.

If we have established that we have jurisdiction to deal with an application, we will then carry out a further review to establish whether it is viable.

In discharging our obligations under section 29E(5) of the Act, we will apply a materiality threshold that must, in general, be met before a departure from the charges scheme will be granted. Accordingly, each section 29E application must meet that materiality threshold to be a viable application.

In respect of section 29E applications made during the first year following the market going live, the Commission has set a materiality threshold of £250,000 in NPV terms of savings (or additional costs) to Scottish Water.

However, even if an application under section 29E does not meet the materiality threshold as set by the Commission, we, in accordance with section 29E(2)(b) of the Act, may still accept the application as viable if, in our view, the application raises an issue of public, market or regulatory importance. An example of where the Commission may accept an application where the materiality threshold has not been met is where the proposal would have a significant environmental benefit.

We will aim to establish if we have jurisdiction and whether an application is viable within 20 business days of opening the case.

### **Stage 3: Assess if further information is required**

We would expect Scottish Water to approach us with information that is reliable and relevant. If we have doubts as to the reliability or relevance of any information submitted to us, we may have to undertake further enquiries.

We may seek information from either or both of the customer and the licensed provider directly. It is our preference to consider applications by written correspondence. We may request meetings with the licensed providers or customers concerned or Scottish Water in order to clarify points made in Scottish Water's submission or any other submissions we receive or to clarify any other relevant matters. In general we expect to hold such meetings separately, however, we may be willing to hold a joint meeting if the parties agree. We will agree minutes of any meeting with the respective parties and share these with the other parties once agreed.

If we require further information to allow us to process the application, we will aim to notify Scottish Water or the other parties within 20 business days of opening the case. Any information requested by the Commission must be supplied to us within 3 months (or such other time as the Commission may specify) otherwise we will close the case and advise Scottish Water.

### **Stage 4: Further advice**

Once we have all information from Scottish Water and the other parties we may need to commission consultancy work.

In addition, if we identify issues that affect either the Scottish Environment Protection Agency (SEPA) or the Drinking Water Quality Regulator (DWQR) we will seek their views on the question.

These more complex questions will take longer to process. However, we will keep Scottish Water and the other parties informed of progress.

We will normally allow the other parties and Scottish Water to comment on the scope of our review prior to it commencing. We will ask Scottish Water and the other relevant parties to comment within 20 business days.

## **Stage 5: Draft determination issued**

A determination will include our decision on the question referred as to whether we consent to a departure from a charges scheme. We will also explain the reasoning for our determination.

We expect our determinations to consist of the following sections:

- Introduction;
- Background;
- Summaries of submissions by parties;
- Any representations by parties;
- Consideration of main issues; and
- Decision

We will endeavour to issue a draft determination 30 business days from receipt of the final piece of information the Commission requires to consider the application.

If we consider that either SEPA or the DWQR has a material interest in the outcome of a determination, we will send copies of the draft determination to them for comment.

We will ask for responses to our draft determination. We expect to receive these within 30 business days. However, we may agree a longer response period if a party requires this.

## **Stage 6: Final determination issued**

We will normally issue a final determination within 30 business days of receiving responses to the draft determination. We will take these responses into account in framing the final determination.

Should we consent to a departure from a charges scheme we will, pursuant to our powers under section 29E(3) of the Act, divide the benefit of any saving between Scottish Water, the customer and the licensed provider in proportions to be decided. The proportions awarded to Scottish Water, the customer and the licensed provider will be subject to review from time to time.

For example, if we consider that Scottish Water is writing-off too many assets under the section 29E arrangements, its share of any saving may be reduced, whereas if Scottish Water is not writing-off enough assets its share may be increased. Likewise, if Scottish Water writes back assets we may vary its share of any saving.

We will set out how the benefit of any saving will be divided between Scottish Water, the customer and the licensed provider in the final determination.

Scottish Water is required to give effect to our final determination.

### **Stage 7: Costs**

As the Act does not permit us to charge either Scottish Water, the relevant licensed provider or its customer for an application under section 29E, all the costs of processing any such application will be borne by the Commission.

### **Stage 8: Publication**

Where we consent to a departure from a charges scheme then, in accordance with section 29E(9) of the Act, Scottish Water must publish details of that departure.

However, where we do not agree to a departure we will, in accordance with section 29E(4) of the Act, give our reasons for doing so.

We intend to publish a summary of each of our decisions on our website. We will aim to do this within 30 business days of issuing a final determination.

### **Stage 9: Appeals**

Any appeal against a final determination issued by the Commission will be referred to the Office of Fair Trading and/or the Competition Commission.

