

Section 8

Conclusions, Advice and Recommendations

Section 8: Chapter 40

Conclusions, Advice and Recommendations

a) Conclusion

i) Introduction

This Strategic Review has been commissioned at a very opportune time. The proposed creation of Scottish Water will benefit customers throughout Scotland, particularly those who were previously served by the North of Scotland Water Authority. The efficiencies that have been identified during nearly two years of analysis by my office will ensure that customers in the East of Scotland Water Authority and West of Scotland Water Authority areas will also be beneficiaries of the move to a single authority. Customers in the East and West will get lower prices and better standards of service than would otherwise have been possible.

There are also clear benefits for customers that will result from the introduction of competition. This will fundamentally change the operating environment for water services providers. Competition will force costs down and will encourage improvements in the levels of service offered to customers. Service providers who consider competition as an opportunity are far more likely to benefit than those who try to resist. If the water industry in Scotland can approach the frontier of efficiency and offer customers tariffs that broadly reflect costs, then there need only be, at worst, a marginal impact on revenue. Customers will be the clear winners – they will benefit from better service and lower charges than would otherwise have been the case.

There will also be clear benefits to customers from the proposed investment programme, which was outlined in the Scottish Executive's Quality and Standards Paper. Not only will this investment improve further water quality and the environment, it will also ensure that assets are properly maintained and are replaced in a way that will minimise costs for customers. This is all in the interests of customers. It is vital, however, that customers can be confident that the environmental improvements, which are promised to result from the increased level of charges, are actually delivered. It is important, therefore, that the outputs of the proposed investment programme are rigorously monitored. I have already begun working with the Scottish Environment Protection Agency and the Water Quality Regulator to define how this monitoring can best be implemented. Coordination between all three regulatory functions will be essential.

ii) Value for money

In this period of rapid change, the interests of customers are best protected by a return to first principles. Ultimately, customers want a reliable service at an affordable price. This means that the primary duty of the regulator in promoting the interests of customers is to put pressure on the water industry to reduce its costs while at the same time delivering a better service to customers. This Review contains a number of important recommendations that will improve value for money to customers, both in the short term and in the future. My Review also suggests that a concerted effort should be made to address the problem of bad debt in Scotland. This is costing the average domestic customer in Scotland £12 per year. It is currently costing the average customer of the West of Scotland Water Authority £17 per year.

The interests of customers require that the water industry is financially sustainable over the long term. There is a clear consensus that the water industry in Scotland should remain in the public sector. The proposed move to Scottish Water will help to ensure that the public sector model is sustainable. My risk analysis demonstrates very clearly that the outlook for prices for all customers and for public expenditure is better if the merger takes place.

Scottish Water is not, however, a panacea. There are significant challenges that lie ahead. Customers must understand that current levels of investment in the water industry are not exceptional - there is a likelihood that investment will have to continue at current levels for the foreseeable future. Borrowing more to make ends meet now may seem, on the face of it, attractive, but it is an illusion. It will result only in much higher bills later and the cost in today's money for customers of the future would be higher.

iii) The efficiency challenge

Price increases for customers will be significant over the next four years. The central challenge for management is to deliver an efficient water industry in Scotland. The future of water services in the public sector in Scotland will fundamentally depend on management and workers bringing their organisation much closer to the efficiency frontier. Failure to deliver the efficiency targets would mean that even more significant increases would be required and that water charges in Scotland would be the highest in the UK by a considerable margin.

Success in delivering the efficiency targets will mean that the lower costs of capital in the public sector will offset the costs associated with serving a large rural population in Scotland. This will allow prices to be kept to around the UK average for all customers, from Stranraer to Stromness. Not only will charges for customers be unacceptably high if the efficiencies are not delivered but relatively high costs would also increase the chances of private companies being able to enter the Scottish water services market successfully.

Regulation has an important role to play in ensuring that the efficiencies are delivered. I intend to continue to regulate in a way that is robust, but fair. This is in the interests of customers.

There are some other significant challenges that need to be addressed head on. These include:

- the framework for competition,
- tools for success in the competitive market,
- governance issues,
- affordability,
- sustainability.

I will recap briefly on the challenges and opportunities presented by each of these issues below.

Framework for competition:

The proposed licensing framework will play an important role in facilitating fair competition. Customers will not benefit from 'cherry-picking'. It is vital to recognise that competition is already a reality and that the best defence for an incumbent is improving efficiency and levels of service. It is important and in the customer's interest that the opportunities and challenges that are presented by competition should be embraced. If the Scottish industry is perceived to offer value for money, then customers will choose to stay with the incumbent supplier.

There is only a very limited gross margin in the retail of water and sewerage services and there is not the opportunity for some of the large discounts, that have been offered in the electricity and gas sectors to tempt customers to switch supplier. Loss of customers is therefore more likely to result from failures in customer service. I am confident that the proposed Scottish Water can deliver value for money for

customers; the recent appointment of an experienced Chief Executive who has experience of improving the efficiency of a water business is to be welcomed. Delivery of value for money to customers will benefit not only the customer; it will also benefit the managers and employees of the industry.

Tools for success in the competitive market

Improving the level of service and increasing efficiency are key to success in any competitive market. The industry in Scotland will also need to develop tariffs that broadly reflect costs. This will require the authority to develop a detailed understanding of the costs of each element of service provision. Accounting separation of the discrete activities: networks and treatment, retail, and value added services, will help. It will be equally important, however, to understand the economics of supply. Costs do not depend materially on water consumption but rather on access to the water distribution and sewage collection infrastructures. This is likely to mean a rebalancing of tariffs away from volumetric charges towards higher fixed charges. This will result in fairer charges for all customers, as there will be a greater connection between the burden placed on the system by any customer and the charge that customer pays.

Governance issues

It is important that the public sector supplier is not at any disadvantage in its operations. This means that high quality management must be attracted to work for the authority and that they are properly and transparently incentivised in order to deliver the value for money that customers require. There will be a number of difficult decisions for managers as they attempt to deliver value to customers. It is, however, important that they are allowed the freedom to deliver the efficiency targets and improved levels of customer service in the most sustainable way, within the agreed revenue cap.

They will have to account to the board and ultimately to all of us, as customers, for their performance. Accountability for management decisions will be best achieved by the recruitment of a high-quality, commercially minded board. This board will then be able to check that management are on track to deliver the value for money required by customers. The Scottish Executive will need to use this board effectively and to ensure that the board is properly empowered to hold managers to

account. Local accountability is also important, but the strengthening of consultation by the authority and a greater role for the Consultative Committees of my office can effectively ensure that this interest is properly represented.

Affordability

Ultimately, the best way to make water bills as affordable as possible for customers in general is to increase the efficiency level of the industry and to deliver the service at the cheapest possible price. This, however, has to be consistent with the principles of financial and environmental sustainability, as only by doing so will there be certainty and stability for future charges.

The extent of non-payment of water bills by customers is significant and will need to be addressed if charges are to remain affordable. Customers who can, but choose not to pay, penalise the most vulnerable customers. It is they who can least afford the extra few pounds on their bill that results from non-payment.

There is, unfortunately, a relatively small number of customers who will find it genuinely difficult to pay their water bill. I recognise that many of these people are already provided with some help because of the progressive nature of the link between domestic bills and the Council Tax Bands and because of the Scottish Executive's initiative in introducing a transitional affordability scheme. There is, however, a strong case for further study of the issue of affordability.

Sustainability

It is important to recognise that action is required to put the Scottish water industry on a sustainable footing. This has nothing to do with competition and would be every bit as true if the vertically integrated monopoly was going to continue unchanged. As a society we have been under-investing in the water infrastructure for a significant number of years. If bills are to be kept at reasonable levels for customers today and in future it will be vital to begin to maintain the assets in a more cost-effective manner. This will require more pro-active management of operational risks in order to avoid storing up shocks for the future. Similarly, it is important that assets are depreciated over realistic lives and that we do not borrow funds that we will not be able repay. These three actions will ensure that charges are maintained at as low a level as is possible without running the

risk of a significant price hike being required to address problems that had been swept under the carpet.

This Review offers a realistic prospect that customers will face stable prices after 2005-06. Declining prices in real terms are a realistic possibility. Meeting the considerable investment needs of the water industry and raising the efficiency of operations and the quality of the customer service provided will be a vindication of the public sector model and something of which all of us can be justifiably proud.

b) Advice to Minister for Environment and Rural Development

I propose that the Minister adopts the following advice, which has been developed as a result of my Strategic Review of Charges:

i) Revenue cap for the three Scottish water authorities

The revenue cap profile for the three Scottish water authorities in the event that the Scottish Parliament does not approve Scottish Water is given in Table 40.1.

ii) Revenue cap for the proposed single authority, Scottish Water

The revenue cap profile for Scottish Water, in the event that the Scottish Parliament approves this initiative is given in Table 40.2.

iii) Harmonisation of charges

Charges should be harmonised across Scotland for both domestic and non-domestic customers, by no later than 2005-06.

iv) Cost reflective tariffs

Scottish Water should seek to develop tariffs that more broadly reflect the economics of the service provided. This will require that the fixed element of the charge faced by customers increases significantly from the current level."

c) Key recommendations

The Minister is invited to accept the following recommendations, which have been developed as a result of my Strategic Review of Charges:

- i) To endorse a joint project between the Water Industry Commissioner, Scottish Environment Protection Agency and

Table 40.1: Revenue cap for the three Scottish water authorities

Water Authority	Projected revenue 2001–02	2002–03	2003–04	2004–05	2005–06	Total increase	
						Actual	Real
East	£249.3m	11.8%	10.3%	11.9%	2.7%	41.7%	28.4%
North	£232.0m	12.4%	11.4%	6.0%	2.5%	36.0%	23.2%
West	£352.2m	10.5%	11.9%	14.3%	2.3%	44.6%	31.0%

Table 40.2: Revenue cap for the proposed single authority, Scottish Water

Water Authority	Projected revenue 2001–02	2002–03	2003–04	2004–05	2005–06	Total increase	
						Actual	Real
Scottish Water	£825.9m ¹	7.5%	7.8%	4.6%	(1.3%)	19.6%	8.4%

the proposed Drinking Water Quality Regulator to ensure that consistent output measures and metrics are collected and monitored. This project will ensure that the environmental and public health benefits and the sustainable industry for which they are paying are actually delivered.

- ii) To instruct the water authorities or the proposed Scottish Water to adopt appropriate accounting separation. A similar accounting separation should also be required by the licence conditions of new entrants to the Scottish water industry.
- iii) To require the publication by my office of annual reports on the performance of the water industry in Scotland. These reports would cover operational costs, delivery of investment and the level of customer service.
- iv) To endorse further study into the affordability of water charges. To instruct water authority management to work with the local authorities and others to improve the support that is offered to vulnerable customers who find it difficult to pay their charges.
- v) To establish clear and public criteria for the payment of incentives to executive directors. These criteria should be based on overall achievement, within the proposed revenue cap, of the required environmental and public health compliance targets and customer service standards.

d) Notes to the advice and recommendations

The Minister is invited to note that:

- i) My advice on revenue caps for the proposed Scottish Water is fully consistent with the public expenditure limits outlined in the commissioning letter. The totals are as in Table 40.3.
- ii) My advice on revenue caps for the three existing authorities is based on the following public expenditure split:

Table 40.3: Revised public expenditure split

Water Authority	2002–03	2003–04	2004–05	2005–06
East	£77.1m	£75.4m	£40.0m	£49.8m
North	£136.6m	£118.8m	£145.2m	£133.0m
West	£100.6m	£105.5m	£114.5m	£116.9m
Total	£314.3m	£299.7m	£299.7m	£299.7m

- iii) My estimate of the impact on domestic charges for the three existing authorities with this revised split of public expenditure is shown in Tables 40.4 and 40.5.

Domestic prices depend in large part upon the percentage of total revenue raised from the non-domestic sector. This percentage ought to reflect broadly the actual costs of supply to the non-domestic sector. At this time, however, there is insufficient cost information to justify any material change in the split of revenue between domestic and non-

¹ Projected 2001-02 revenue for the proposed Scottish Water differs from the sum of the projected revenues from the three existing authorities because of inter-authority trading

Table 40.4: Likely impact on domestic prices for the three authorities under revised public expenditure split

Water Authority	2002–03	2003–04	2004–05	2005–06	Total increase	
					Actual	Real
East	12.0%	10.3%	12.0%	2.0%	41.1%	27.9%
North	12.0%	11.0%	5.5%	2.0%	33.8%	21.2%
West	10.5%	12.0%	14.5%	1.5%	43.8%	30.3%

Table 40.5: Resulting Band D charge

Water Authority	2001–02	2002–03	2003–04	2004–05	2005–06	Total increase
East	£270.00	c.£303	c.£333	c.£374	c.£381	c.£111
North	£350.18	c.£395	c.£440	c.£465	c.£474	c.£124
West	£266.40	c.£294	c.£330	c.£377	c.£383	c.£117

Table 40.6: Likely impact on domestic prices under the proposed Scottish Water

Water Authority	2002–03	2003–04	2004–05	2005–06	Total increase	
					Actual	Real
Scotland	7.2%	7.4%	4.1%	0.0%	19.9%	8.6%
East	9.9%	9.9%	5.2%	0.0%	27.1%	15.1%
North	0.0%	0.0%	(2.1%)	0.0%	(2.1%)	(11.3%)
West	9.9%	9.9%	6.6%	0.0%	28.8%	16.6%

Table 40.7: Resulting Band D charge²

Water Authority	2001–02	2002–03	2003–04	2004–05	2005–06	Total increase
East	£270.00	c.£296	c.£325	c.£343	c.£343	c.£73
North	£350.18	c.£350	c.£350	c.£343	c.£343	(c. £7)
West	£266.40	c.£293	c.£321	c.£343	c.£343	c.£77

Table 40.8: Revenue caps for the three water authorities in the event of the current public expenditure split

Water Authority	Revenue 2001–02	2002–03	2003–04	2004–05	2005–06	Total increase	
						Actual	Real
East	£249.3m	11.8%	8.3%	5.9%	3.2%	32.3%	19.9%
North	£232.0m	17.4%	5.5%	20.1%	0.5%	49.5%	35.4%
West	£352.2m	10.5%	11.9%	16.4%	2.7%	47.8%	33.9%

Table 40.9: Current public expenditure split

Water Authority	2002–03	2003–04	2004–05	2005–06
East	£87.1m	£83.1m	£83.1m	£83.1m
North	£116.6m	£111.1m	£111.1m	£111.1m
West	£110.6m	£105.5m	£105.5m	£105.5m
Total	£314.3m	£299.7m	£299.7m	£299.7m

domestic customers. It is possible that detailed cost information could suggest a lower contribution from large business and a slightly higher contribution from domestic customers and smaller businesses. If such information becomes available, the likely maximum impact on the projected domestic charges is likely to be between 5% and 10%. Any such increase should, of course, be phased to ensure that charges remain as affordable as possible.

- iv) My estimate of the impact on domestic charges in the event that Scottish Water is established is shown in Tables 40.6 and 40.7. See notes to d (iii) above.

² I have calculated the Band D charge separately for water and wastewater. In Table 40.7 I have presented the total estimated bill, assuming the customer is connected to both the water and wastewater service.

Table 40.10: Likely impact on domestic prices for the three authorities under current public expenditure split

Water Authority	2002-03	2003-04	2004-05	2005-06	Total increase	
					Actual	Real
East	12.0%	8.1%	5.5%	2.5%	30.9%	18.6%
North	17.0%	5.0%	19.8%	0.0%	47.2%	33.3%
West	10.5%	12.0%	16.8%	2.0%	47.4%	33.6%

Table 40.11: Resulting Band D charge

Water Authority	2001-02	2002-03	2003-04	2004-05	2005-06	Total increase
East	£270.00	c.£303	c.£327	c.£345	c.£354	c.£84
North	£350.18	c.£411	c.£433	c.£522	c.£522	c.£172
West	£266.40	c.£294	c.£330	c.£385	c.£393	c.£127

Table 40.12: Operating cost efficiency targets

Water Authority	2002-03	2003-04	2004-05	2005-06
Scotland (Total)	£63.0m	£96.9m	£115.9m	£135.8m
East	£13.1m	£20.2m	£24.2m	£28.3m
North	£14.9m	£22.9m	£27.4m	£32.1m
West	£35.0m	£53.9m	£64.4m	£75.4m

Table 40.13: Capital expenditure efficiency targets

Water Authority	2002-03	2003-04	2004-05	2005-06
Scotland (Total)	£70.8m	£102.1m	£169.1m	£207.0m
East	£0.0m	£8.7m	£18.8m	£29.3m
North	£34.8m	£40.6m	£66.0m	£73.2m
West	£36.1m	£52.8m	£84.2m	£104.5m

- x) The dual homes discount cannot be justified by the economics of water supply and sewage collection. While it is true that less water may be used in a second household, this reduces costs of supply only very marginally. In essence this means that dual homeowners are in receipt of a subsidy from other households. Furthermore, in a competitive retail market it may not be possible to maintain this individual allowance and the link to property bands. Ministers may wish to consider whether this discount, as currently applied, cannot be better targeted at vulnerable customers.

Water Industry Commissioner for Scotland
15 October 2001

- v) In the event that the current split of public expenditure between the three authorities is maintained, the revenue caps shown in Table 40.8 would be required.
- vi) This split of public expenditure would be as shown in Table 40.9.
- vii) My estimate of the impact on domestic charges would be as shown in Tables 40.10 and 40.11. See notes to d (iii) above.
- viii) The proposed revenue caps for the proposed Scottish Water and for the existing three authorities assume the operating cost efficiency targets, from a 2000-01 base, shown in Table 40.12.
- ix) These revenue caps also assume the capital expenditure efficiency targets, from a 2000-01 base, shown in Table 40.13.