

## **Building a Hydro Nation – A Consultation: Response from the Water Industry Commission for Scotland**

The Commission has reviewed the Scottish Government's Consultation on Building a Hydro-Nation. There are some important issues raised in the Consultation and much that the Commission would support. There are a number of other issues, which do not relate to the core business of Scottish Water or the retail competition framework, which the Commission considers are matters for Scottish Water, the Scottish Government and, ultimately, the Scottish Parliament to decide.

The Commission has recently published its assessment of Scottish Water's performance during the last regulatory control period, which ended in March 2010. This concluded that Scottish Water had responded very positively to the challenges set out by the Commission in its determination of charges in November 2005. Scottish Water succeeded in delivering the Scottish Government's objectives for £100 million less than was allowed by the Commission. This allowance was already some £1.5 billion less than the company had said that it would need in its business plan. Scottish Water should be congratulated on its performance. Scottish Water also succeeded in improving its leakage and its customer service by more than the challenge set out by the Commission. These improvements are worth around £175 million to customers.

The key to effective economic regulation is the establishment of a clear and wholly unambiguous budget constraint. This requires that Scottish Water has certainty of the resources that will be available to it and that these resources are focused solely on the delivery of the ministerial objectives, which are financed by the Commission in its determination. This does not preclude Scottish Water from pursuing other non-core activities, which could bring benefits either in financial or outcomes terms for the people of Scotland. It would be for the Board of Scottish Water, the Scottish Government and, ultimately, the Scottish Parliament to decide which activities should be pursued and how they should be financed. The Commission considers that such activities should not be financed by the core business – unless the Scottish Government makes an explicit and public decision that this is what it considers to be in the interests of the people of Scotland and makes it clear what the impact on charges would be. Such investments may bring benefits but it is for the Government to set out a case to charge payers in Scotland.

In this regard, it will be important to ensure that care is taken not to breach the European rules on State Aid and the European and UK competition laws. It would be particularly important that any new non-core functions considered important by Scottish Water or the Scottish Government are pursued in a separate subsidiary company that is adequately ring-fenced. The Scottish Government should also consider how such activities are monitored – or whether they need to be regulated – particularly if they decide to risk customers' money in these new activities.

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The Commission faced just such a challenge in implementing the competition framework, the principles for which were set out in the Water Services etc. (Scotland) Act 2005. To avoid a situation where Scottish Water could have been in breach of UK and European competition law, we had to set up a robust ring-fence around the activities of Scottish Water's retail subsidiary Business Stream. This was necessary because it was the only way of ensuring that a properly arm's length relationship could be established between the wholesale business of Scottish Water and its retail operations.

The Commission would welcome the establishment of a holding company, which could include at least three subsidiaries dealing with the wholesale activities, the retail activities and the non-core activities (both the current such activities and any new initiatives) of the Scottish Water Group. This would make our regulation of the core business more transparent. It would also provide the necessary reassurance to customers that their charges are being used to deliver the services they have been promised when the regulator finances the ministerial objectives at the lowest reasonable overall cost.

If a holding company were to be established, it would be important that the core wholesale business of Scottish Water were licensed in much the same way as its retail subsidiary. Such a licence could be simpler than those that exist for the appointed water and sewerage companies in England and Wales, but should make it clear that there is a defined purpose of the core business and a defined method by which its activities are funded. We would be happy to work with the Government on developing a suitable licence.

The Commission further agrees with the Scottish Government that the extension of the retail competition framework to the rest of Great Britain would bring further benefits to customers in Scotland. We recently set out the results of the new framework in our annual report on competition. Benefits to customers are substantial – some are financial, some environmental, and in most cases there has been a step change in terms of the level of service provided. By tailoring water services to customers, it is likely to be much easier to reduce water usage and the carbon footprints of businesses. These are benefits that will also help Scotland achieve its environmental goals.

In a pan-GB market, there is likely to be more intense competition and we would expect the tailoring of services to customers to become ever more innovative and, potentially, for costs to fall further. This would be a significant benefit to the people of Scotland. The Commission considers it important to work with the Scottish Government, Defra and Ofwat to help bring about this result.

The Commission has also noted the potential grant of concurrency powers under the Competition Act 1998. It understands that such a grant would have to be made by the Department for Business, Innovation and Skills at Westminster. The Commission believes that there could be merit in seeking concurrency powers for the Commission – particularly if it is to have a role, jointly with Ofwat, in monitoring a pan-GB competition framework.