

**Holyrood Conference:
Turning the Tide, The Future of Scotland's Water**
3 March 2008 in Edinburgh



Holyrood Conference: The Future of Scotland's Water

Introduction

The Water Industry Commission for Scotland was established in July 2005 by the Water Services etc. (Scotland) Act. This Act significantly strengthened the governance arrangements for the water industry in Scotland.

The Commission is responsible for the economic regulation of Scottish Water and has the power to set charges. Previously, the Water Industry Commissioner could only advise the Scottish Ministers on the appropriate level of charges.

The Commission is also responsible for establishing the framework for competition in the Scottish water industry.

My talk to-day breaks down into four areas:

- An update on the performance of Scottish Water;
- A review of the Strategic Review of Charges 2010-14 (and the likely prospects for prices);
- How the new competition framework will work; and
- A summary of the benefits of this new competition framework; both the medium term potential and the potential already realised.

An update on the performance of Scottish Water

In our role as economic regulator we monitor and report on Scottish Water's performance. We consider its progress in delivering the Government's objectives within its agreed budget. We published our last assessment of Scottish Water's performance in 2006-07 in the autumn of last year.

In most areas Scottish Water is performing very well. In the period 2002-2007, Scottish Water reduced its operating costs in real terms by £170 million per year. It improved the efficiency of its capital investment delivery during the first regulatory control period (2002-2006) by 22% or £494 million. This improvement in efficiency has benefitted customers. The average household now has a bill that is some £90 a year lower than it would otherwise have been. The early indications for the current financial year are that Scottish Water is continuing to improve its efficiency.

The improvement in the level of customer service provided by Scottish Water has also improved markedly. We measure the level of service provided using an index of measures, weighted by their importance to customers. We call this index the Overall Performance Assessment or OPA. On this measure, Scottish Water improved its score from 165 to 232 during 2006-07. It is well on target to achieve the 250 required by 2010.

But there is no room for any complacency. Scottish Water is currently charged with the delivery of the largest investment programme in Great Britain (on a per connected property basis). Only Thames Water has a large investment programme and it serves about 1.5 times as many water customers and over twice as many sewerage customers. It is a matter of record that Scottish Water made a slow start to the delivery of this programme. We remain concerned that delivering the remainder of this programme efficiently by the end of March 2010 will be a major challenge. We are monitoring progress very carefully.

As an aside, I have heard recently about great backlogs of investment in Scotland. This assertion simply does not stand scrutiny. Investment per connected property in Scotland between 1982 (well before privatisation in England) and 2006 was actually higher than in England and Wales. Scottish customers have, therefore, made their contribution.

In setting prices, the Commission required that Scottish Water made substantial progress towards its economic level of leakage. Although Scottish Water reduced its leakage from 1,104 MI/day to 1,004 MI/day, it fell short of our target by 44 MI/day. There can be no question that the current level of leakage is too high, but Scottish Water is beginning to make progress. Again, we will hold Scottish Water to account for its performance in this area.

Setting Prices

The Government decides on the outcomes which Scottish Water should achieve and the principles of charging that the Commission should apply. Our duty is to set charges at a level consistent with Scottish Water delivering these objectives for the lowest reasonable overall cost. In so doing, we take account of the scope for improvement in the efficiency of Scottish Water. We also consider the impact of environmental and public health improvements and of new connections to Scottish Water's infrastructure.

It is important to point out that Scottish Water can ask us to refer our determination to the Competition Commission if it believes that it cannot deliver all of the improvements required by the Government within the resources that we have allowed. However, this is not a one way bet. The Competition Commission would consider again all the available evidence and set its own charge caps. These could be the same as, higher, or lower than those that we had set. And these revised caps would be binding.

Our work on the Strategic Review of Charges began in the autumn of 2006- only about 6 months after the price caps for the current regulatory period had come into force. We published a timetable for the Review for consultation at the end of December 2006. The key dates in this timetable are:

December 2007: We issued guidance to Scottish Water on its first draft business plan

May 2008: Scottish Water submits its first draft business plan

July 2008: We respond to Scottish Water's plan

October 2008: We issue guidance to Scottish Water on its second draft business plan

March 2009: Scottish Water submits its second draft business plan

End June 2009: We publish our draft determination of charges

September 2009: Deadline for representations on our draft determination

End November 2009: We publish our final determination.

We have scheduled a number of stakeholder information days during this time which are an opportunity for stakeholders to understand how our thinking is developing. This is also an opportunity for you to influence our approach to setting prices for the 2010-14 regulatory control period.

However, at this stage, we can see no reason why the current benign outlook for water and sewerage charges cannot continue beyond 2010. The strengthened governance arrangements, the Government's commitment not to take a dividend and the continuing improved performance of Scottish Water are all contributory factors to this positive outlook for customers' charges.

But, I must sound one word of caution. If cross-subsidies between classes of non-household customers are to be removed in line with the Scottish Government's proposals in its consultation on the principles of charging, trade effluent customers will see increases in their bills.

We believe that there is no reason to maintain these cross-subsidies and that the principle of "the polluter pays" is appropriate here. The extent of the longer term increase will be greater for those organisations, which are currently paying less than the published tariff. We consulted on these adjustments at the end of 2006.

The flip side is that customers who do not use trade effluent services can look forward to relatively lower bills. Their bills will increase less quickly than the overall non-household price cap set by the Commission and may even reduce.

I now want to turn to another important factor. It is probably the most significant change in the water industry in Great Britain for some 20 years. Perhaps it is the most significant change ever to affect the industry in Scotland.

Real choice... Competition..... is coming to the water and sewerage industry in Scotland. Competition in the Scottish water industry will help ensure that customers see further significant improvements in value for money. The Scottish framework is quite different to that which currently exists south of the border. In Scotland, unlike England and Wales, the rules of the game, the level of prices are all clear and published. They do not depend upon negotiation between a new entrant and the incumbent. This is bad for customers.

Organisations in Scotland will be the first, anywhere in the world, to have such a genuine opportunity to choose their water and sewerage supplier. On 1 April this year, all organisations in Scotland from the smallest newsagent in the Western Isles to the largest industrial sites; from small council offices to leisure centres and hospitals will be able to choose who supplies their water and sewerage services.

Customers amongst you may already have noticed a change in your bills. This is because, in line with the provisions of the 2005 Act, we required Scottish Water to create a separate organisation to supply retail services to non-household customers. Scottish Water established Business Stream during 2006 and it is now supplying all of Scottish Water's non-household customers. Perhaps they have explained the changes in the Scottish water market. But we must emphasise that, in the future, Business Stream will have to compete on an equal footing with the other licensed suppliers.

So far, we have licensed two other suppliers: Aquavitae and Satec. Osprey Ltd., a subsidiary company of the Anglian Water Group, has also applied for a licence. Others will follow. The Commission expects to license more entrants ranging from the small to the very large.

How will these new arrangements work?

Under the new arrangements, Scottish Water will continue to provide services to its 2.2 million household customers. It will also retain control of Scotland's publicly owned network of pipes, sewers and treatment works.

The market will operate in much the same way as in other utility services (although it is worth noting that wholesale charges will be regulated and hence there need not be the high level of volatility in retail prices that has recently characterised the energy markets). The new suppliers will buy wholesale services, (the physical supply of water and removal of sewage) from Scottish Water.

A new organisation - the Central Market Agency - will administer the market codes, calculate wholesale bills and register switches of supplier by customer. I am reliably informed by the Service Provider that they are confident that their systems could cope no matter how many customers decide to switch supplier.

I want to be quite clear. No customer - not a single business or household - will be worse off as a result of the introduction of competition. We have made it a license condition that all new retailers are obliged to offer a "default" level of service and tariff to any customer, anywhere in Scotland. There can be no question of smaller customers, or of those living in remote areas, being excluded from the benefits of choice. They too will be able to choose the supplier who best meets their needs. The Commission will respond robustly if it suspects any licensed provider is attempt to discriminate unfairly between customers. Let me be clear - any business has a clear right to return to any previous supplier and pay no more than the appropriate "default" tariff.

And, you can be assured that the Commission will set charges for Scottish Water's regulated wholesale business no higher than is absolutely necessary. Indeed these will actually be lower because of the introduction of the new competition framework. Our initial analysis shows that the Scottish water industry's costs have already fallen as a result of its preparation to deal with the threat of competition. A copy of our analysis is available to those of you who are interested.

How will customers benefit?

In our view customers may benefit both from an enhance level of service and from lower bills. There may also be significant environmental benefits that result from the new framework.

One of the most obvious potential benefits may be in the provision of advice on water efficiency to customers. If the retail activity is separated, it is more likely that customers will receive appropriate advice in this area. In a competitive market, the retailer will not be concerned by the wholesaler's level of capacity utilisation (even if they are under the same ownership). A company under the same ownership as the local infrastructure company cannot afford to worry because, quite simply, other retailers will not..... The customer and the environment will benefit.

The new competition framework marks an end to the "one size fits all" approach. For example, I am aware of some customers, operating complex sites, who can receive several hundred bills a year. Not only does that make it difficult for the customer to understand whether it is using water in an efficient and environmentally friendly way, but each of these bills needs to be processed with all the resulting overhead.

Consolidated billing, whether for single sites with complex water supply arrangements or for organisations with very large estates, could result in savings on the current level of bills and in much reduced administration costs. And there must also be scope for paperless billing.

For small businesses, there may be the prospect of a future single utility bill, covering electricity, gas, water and sewerage. Some of the other value added service offered by utilities (such as emergency assistance, boiler and pipe repairs) may also be coordinated, improving the value for money offered to customers.

For other larger customers, there may be an opportunity to agree an improved and tailored service that could be substantially cheaper. There is provision in law that new suppliers and their customers will benefit if they help Scottish Water to reduce its costs. Discounts may be available to organisations that can plan their water use or waste disposal (for example by restricting their use of water at certain times of day); there may also be opportunities for developers to work with Scottish Water and realise benefits. We will shortly publish further detailed information on how a customer who can reduce Scottish Water's costs of providing the service may apply for the discount to which he is entitled.

Looking forward, we have required Scottish Water to provide detailed information about its costs and activities across its whole value chain. This information will be available in October. We expect that this may reveal scope for further efficiency and, consequently, better value for money for customers.

Conclusion

Scottish Water has come a long way in the nearly six years since it was established. It has reduced its operating costs significantly and, at the same time, improved the level of service it provides to customers.

It has also improved its compliance with more demanding environmental and public health standards, and in the last 18 months, has responded much more effectively to the needs of developers. There is much here to commend the public sector model for Scotland's water industry.

The outlook for prices may be benign, but challenges remain. We must ensure that there is no complacency. Scottish Water still faces a significant challenge to deliver the remainder of the investment required, and financed, by customers in this regulatory control period. It also needs to reduce the level of leakage.

The introduction of competition to the Scottish water industry is already beginning to lower the industry's costs. Levels of service are also likely to improve. But competition typically brings innovation and the separation of retail and wholesale activities is likely to encourage more efficient use of water by businesses. Scotland is a pioneer in the introduction of competition to the water industry. Scottish businesses will undoubtedly benefit.

The strengthened governance framework and independent economic regulation have already transformed the water industry in Scotland. The introduction of competition will be a further catalyst for improvement.

Six years ago, the industry in Scotland faced challenges on every front. We have made a lot of progress – but, I repeat, there is further to go. If we continue to make progress, perhaps others will learn from the Scottish model for the delivery of water services. Our model combines high quality, appropriately incentivised, management and staff and the best of public service.

Alan Sutherland

Chief Executive, Water Industry Commission for Scotland

3.03.08



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