

## **WATER INDUSTRY (SCOTLAND) ACT 2002**

### **SCOTTISH MINISTERS' STATEMENT OF POLICY REGARDING CHARGES**

#### **Introduction**

1. The Scottish Ministers (“Ministers”) in performance of the duty placed on them by section 29D of the Water Industry (Scotland) Act 2002 (“the 2002 Act”), having consulted the Water Industry Commission for Scotland (“the Commission”), Scottish Water (“SW”) and the Convener of the Water Customer Consultation Panels (“the Convener”) make the following statement of policy regarding charges under a charges scheme under section 29A, and a determination of maximum charges under section 29B, of the 2002 Act for the period 1 April 2006 to 31 March 2010 (“the period”).

#### **Ministers’ policy regarding charges**

##### *General policy objectives*

2. Ministers’ policy is for maximum charges to be determined for the period and for successive charges schemes under that determination in the period to be made so as to enable SW to:

- a) achieve the maximum affordable improvements in public health and environment protection standards;
- b) support housing and Ministers’ top priority of economic growth in communities across Scotland through investment in new water and sewerage capacity; and
- c) achieve the preceding two outcomes, and also improvements in operating performance, on the basis of charges that are affordable and stable across the period and that are sustainable in the long term.

##### *Full cost recovery: Ministers’ policy on providing financial support to SW*

3. Ministers have decided that public expenditure support to SW in the provision of its core services throughout the period will take the form solely of lending from Ministers to SW, and that no grant will be paid in respect of these services during the period. Information about the level of that lending is given in the next section.

4. It is the policy of Ministers that customers should be asked to meet additional costs beyond those allowed for in a charges determination only where these have arisen as the result of external factors beyond the control of SW. The purpose of this policy is to protect the position of customers. To provide similar protection for public expenditure, it is the policy of Ministers not to increase their lending to SW to meet costs already provided for by a determination. The purpose of this policy is to ensure that the determination provides SW with firm financial limits for the period covered by the determination.

*Stable charges, financial sustainability and the level of Ministers' lending to SW*

5. Having had regard to the advice submitted to them by the former Water Industry Commissioner for Scotland (in his letters to them of 2 December 2004 and 10 May 2005), Ministers have established as a policy objective that average charge levels should be kept constant in real terms during the period. Consequently, insofar as is practicable, and subject to the conditions set out at paragraphs 6 and 7 below, Ministers require the Commission and SW to discharge their respective functions under sections 29A and 29B of the 2002 Act in such a way that maximum charges are determined and charges schemes are made with a view to securing that objective.

6. Achieving constant average charges in real terms could be consistent with some charges rising above inflation and others falling in real terms, for example where tariff rebalancing is justified. Where this is necessary, Ministers require the Commission and SW to minimise the impact on those customers affected by any increase. Consequently, maximum charges should be determined and charges schemes made in a manner that delivers the most regular and smooth charges profile possible in the circumstances. In particular, Ministers require the Commission and SW to avoid reductions in charges one year if such a reduction could not be sustained, or if it would need to be followed in subsequent years by an increase in real terms. The Commission and SW should ensure, where a permanent increase in a given tariff is necessary, that the increase is phased over the review period unless there is a more effective means of minimising the impact of the increase.

7. Ministers do not wish stable charges in the period to be secured at the expense of SW's longer-term financial sustainability. That is to say, they do not wish charges to be kept low in the medium term by building up debt whose servicing costs would add to SW's cost base and would result in charges in the longer term being higher than would otherwise have been the case. To safeguard the position of customers in the longer term, Ministers' policy is, as a minimum, that SW's financial strength should be maintained during the period and that if possible it should be improved slowly over that time.

8. Ministers recognise that the level of borrowing during the period that would be consistent with long-term financial sustainability will be dependent on the maximum size of the capital programme that the Commission, as part of the assessment required in determining maximum charges, judges SW to be capable of delivering efficiently in the period. Therefore, Ministers wish the Commission to determine the amount of lending that they should make available to SW in each year of the period that would be necessary to support a capital programme of the scale set by the Commission and that would be consistent with a gradual and steady improvement in the long-term financial sustainability of SW. This requirement is subject to the amount of lending by Ministers in any one year in support of the investment programme being no greater than £182 million, which is the maximum sum that the Executive has set aside for lending to SW in the each year of the period, pending the determination of maximum charges and the Commission's decision on the sustainable level of borrowing required to underpin the determination and the investment programme.

9. In addition to the lending that Ministers will make available for the achievement of their objectives during the period, Ministers will make available any lending provided for the period 1 April 2002 to 31 March 2006 that has not be drawn down by SW and which is required to meet the costs of any investment from that period, but which is completed between 1 April 2006 and 31 March 2010.

#### *Harmonised charges*

10. A fundamental tenet of Ministers' policy regarding charges is that customers in the same group should pay at the same rate for the provision of the same service, regardless of their location, or of the actual cost of serving one such customer as against another. Section 29D(2) of the 2002 Act enshrines this principle in statute by requiring Ministers to set policy regarding charges that secures that outcome. Consequently, Ministers confirm that charges for all of SW's core services in the period must be recovered from customers on the basis of all tariffs being set at a nationally averaged rate for Scotland as a whole. This means that charges in respect of given services to particular customer groups should be set to recover the cost to SW nationally of providing that service to that group as a whole. Where, for whatever reason, this requirement gives rise to significant charge increases for individual customers, the Commission and SW are required to have regard to Ministers' requirement that such increases be phased gradually over the period to minimise the impact of any increase in any one year.

#### *Affordable charges for low income households*

11. Ministers' policy regarding charges generally is directed towards charges being affordable for all customers. Ministers are concerned in particular to ensure that the charges paid by low income households are made as affordable as possible for such households.

12. The 25% discount on water and sewerage charges that single adult households receive automatically at present is one means of assisting many low income households. Ministers confirm that this discount will remain in place after 1 April 2006. In addition to this, Ministers have decided that households with two or more adults and receiving Council Tax Benefit should have their charges reduced by up to 25% from 1 April 2006. They will make regulations, under section 40 of the 2002 Act, which will provide for the new reduction to be introduced. The reduction will be a permanent means of assisting those receiving Council Tax Benefit. Therefore, the present water and sewerage services charges transitional relief scheme, which is also based on Council Tax Benefit eligibility, but is temporary, will come to an end on 31 March 2006, rather than continuing until 31 March 2007 as planned previously.

13. As far as is possible, the cost of providing the new reduction should be met from the additional revenue that SW will recover as a consequence of the discount on water charges that has been available to the owners of premises falling within the scope of the Unoccupied Dwellings Regulations being abolished. In the event that the reduction would result in SW suffering a shortfall in its revenue that is not made up by the extra revenue accruing from the abolition, that shortfall is to be made good by increasing limits on charges generally.

### *Cost reflectivity of charges*

14. An aspect of Ministers' policy on harmonised charges is Ministers' expectation that charges in general should be broadly cost reflective. That is to say, charges in respect of given services to particular customer groups should be set to recover the cost to SW nationally of providing that service to that group as a whole.

15. Ministers recognised concerns in some quarters that charges might not be fully cost reflective and therefore could be balanced unfairly as between one group of customers and another. Consequently, they commissioned economic consultants Stone and Webster to establish and analyse evidence of any imbalances between customer groups and to recommend what, if any, action should be taken to address any clearly identified imbalances.

16. Stone and Webster's report concluded that SW over-recovers costs from non-household customers. The most robust estimate that the report could provide was that this over-recovery results in households paying £44m a year less for water supply services than it costs to provide them with these services.

17. The report recognised that there are particular difficulties in attributing the costs of sewerage services across different customer groups at present. It expected these to diminish over time as the quality of SW's data improves. It recommended therefore that action to address a number of imbalances between sewerage customers should be left until after 31 March 2010.

18. In the period between 1 April 2006 and 31 March 2010, the report recommended a cautious approach that would achieve a measure of general rebalancing between household and non-household charges. It suggested, on the basis of its most robust estimate, that it would be prudent to correct the under-recovery from household customers of £44 million.

19. The former Water Industry Commissioner advised Ministers that it would be possible to rectify the imbalances identified by Stone and Webster as most suitable for addressing in the period without average household charges having to increase in real terms. In light of this advice, Ministers require the Commission to determine charge limits for the period in such a way that these imbalances are corrected without causing average household charges to increase in real terms. In doing so, the Commission should have regard to the requirement that any change in tariffs is phased over the review period unless there is a more effective means of securing the change while maintaining stability in household charge levels.

20. The counterpart to this exercise will be a reduction in the amount paid by non-household customers. Ministers require the Commission to allocate the benefits of this reduction equally across all non-household customers.

21. Rectifying the imbalance identified by Stone and Webster is Ministers' priority in this area for the period. Ministers require the Commission and SW to conduct further work to establish with greater certainty the nature of other such imbalances, particularly in the case of sewerage services. In light of that work the Commission should advise Ministers of any further rebalancing that would be required to achieve greater cost reflectivity in charging in the period 2010-14.

22. Ministers require the Commission to set charges in such a way that any costs of retaining the link between household water and sewerage charges and Council Tax bands, and the new water and sewerage charges discount described at paragraph 12 above, are both funded out of the generality of charges.

*Paying for increased local capacity*

23. SW's infrastructure can be divided into three parts: the pipes and drains from the boundary of individual properties that connect these properties to the local infrastructure; the local infrastructure, such as water mains, sewers, service reservoirs and wastewater pumping stations; and strategic assets, such as raw water intakes, water impounding reservoirs, aqueducts and treatment works.

24. The cost of connecting new developments to the local infrastructure has always been met by the developer. Ministers confirm that this should continue to be the case. In respect of strategic assets, Ministers' policy is that SW should meet the costs of providing whatever enhancements to the capacity of those assets are required to enable new developments to connect to SW's networks. Ministers require the Commission to ensure that its determination of charges provides sufficient financial resources for SW to achieve this objective.

25. Where enhancements to the local infrastructure are required to enable new developments to connect to the public networks, Ministers' policy is that developers should meet the net cost to SW of such enhancements, as determined by reference to the financial benefit to SW of the revenue that it will receive as a consequence of the new connection. Subject to the outcome of a public consultation on the matter, Ministers will provide for that policy to be achieved through regulations made under section 1 of the Sewerage (Scotland) Act 1968 and section 6 of the Water (Scotland) Act 1980. These will limit the contribution that SW is required to make to the local infrastructure costs to a sum that will reflect the additional charge income that it will receive as a result of the new infrastructure vesting in it.

26. The regulations will require that where additional or enhanced local infrastructure is required, developers fund the excess costs of the enhancement or connection above the contribution that SW will make in respect of the income that it will receive from the development. Consistent with the regulations, Ministers require the Commission to ensure that the level of borrowing that it sets for SW is sufficient to enable SW to fund the costs that it will incur in these cases through borrowing, rather than charge income, with reference to the cost of funds to SW and the period over which the contribution is to be amortised.

27. The approach described in the preceding paragraphs does not take into account the cost to SW of reinforcing its infrastructure in response to demands on capacity that cannot be attributed to particular developments. Ministers consider that these costs should be borne by developers generally. Consequently, they require the Commission to provide for SW to levy “infrastructure charges” of £250 for each new property connected to the water infrastructure and of £250 for each new property connected to the sewerage infrastructure.

*Future charging arrangements for non-household customers*

28. Ministers have announced, as a long-term objective of their charging policy, that the rateable value of non-household premises should cease to be the basis upon which non-household customers are charged for any aspect of the services that they receive from SW. They are committed to the introduction of meters for all non-household premises not metered at present and to the creation of a system that would place all non-household premises and their surrounding surface areas into one of a number of bands intended to reflect the area of roof, car parking etc. that discharges to the public sewers.

29. Before these changes are implemented the Scottish Executive will work with the Commission and SW to develop detailed proposals for introducing general non-household metering and banded surface charges. It will consult on these proposals with a view to both changes being implemented as far as is practicable with effect from 1 April 2010. Meantime, Ministers require the Commission to determine charge limits for the period in respect of un-metered premises and of surface drainage on the basis of the existing links to rateable values, using the values held by SW and based on the rateable values in place in March 2000.

30. Pending introduction of these changes, Ministers’ policy, as announced on 31 August 2004, is for premises eligible to be exempted from paying charges in the period 1 April 2002 to 31 March 2006 under the Water and Sewerage Charges (Exemption) (Scotland) Regulations 2002 to continue to be eligible for that exemption in the period 1 April 2006 to 31 March 2010. Ministers will make regulations under section 40 of the 2002 Act to give effect to that policy. They require the Commission and SW, in discharging their respective functions under sections 29A and 29B of the 2002 Act, to have regard to this intention.

*Paying for roads drainage*

31. At present all sewerage customers contribute to the cost of SW’s drainage of roads. Non-household sewerage charges include a separate element to cover these costs; household charges include an unspecified element for the same purpose. Ministers confirm that this approach should continue. Consequently they require the Commission to determine sewerage charges for all customers on the basis that such charges include an appropriate element to recover the cost to SW of draining roads.

*Paying for economic regulation*

32. Ministers confirm that the cost to the Commission of regulating SW should be covered by an annual levy on SW, the level of which they set, funded out of charge income. For the purposes of making its determination, the Commission should assume that during the period it will receive an annual levy broadly equivalent to the present base budget of £1.5 million a year. The Commission should allow for the base budget to be augmented by £150,000 in each year of the period to cover the additional costs arising from the creation of the Commission, by enough to meet the costs that are likely to arise in connection with preparing the determination of charges for 2010-14, and by enough to cover the reasonable costs of employing independent reporters throughout the period.

33. The Commission's costs in the period in connection with establishing the regime to license undertakings providing retail services to the non-household sector will be met from a grant that Ministers will pay to the Commission. Therefore, the determination should not make any provision for these costs.

The Scottish Executive  
28 September 2005