WATER SERVICES ETC. (SCOTLAND) BILL

POLICY MEMORANDUM

INTRODUCTION

1. This document relates to the Water Services etc. (Scotland) Bill introduced in the Scottish Parliament on 11 June 2004. It has been prepared by the Scottish Executive to satisfy Rule 9.3.3(c) of the Parliament’s Standing Orders. The contents are entirely the responsibility of the Scottish Executive and have not been endorsed by the Parliament. Explanatory Notes and other accompanying documents are published separately as SP Bill 23–EN.

POLICY OBJECTIVES OF THE BILL

2. The objective of this Bill is to strengthen the regulatory framework for the water industry, ensuring that there is a robust transparent regime that operates in the interests of all customers. The Bill includes measures to improve the accountability and transparency of the regulator, including replacing the current individual Water Industry Commissioner with a body corporate, the Water Industry Commission for Scotland. The Bill then goes on to give the Water Industry Commission powers of determination over Scottish Water’s charges, and powers to establish a licensing regime to regulate retail competition for non-household customers. The Bill also provides certainty for the water industry and secures Ministers’ public health, environmental protection and social policy objectives by prohibiting common carriage on the public water and sewerage networks, and prohibiting retail competition for household customers.

- **Part 1** of the Bill replaces the Water Industry Commissioner (the Commissioner) with a body corporate, the Water Industry Commission (the Commission), to improve the transparency, accountability and consistency of regulation in the water industry.

- **Part 2** of the Bill makes a series of provisions regarding water and sewerage services:
  - it prohibits common carriage in the water or sewerage systems (sections 4 and 5);
  - establishes a licensing regime for retail competition for non-household premises only, managed by the Water Industry Commission (sections 6 to 11);
  - requires Scottish Water to establish a subsidiary for the purposes of applying for a licence under the Bill (sections 12 and 13);
  - provides for arrangements between Scottish Water and a licensed water or sewerage services provider to supply services to eligible customers, request
This document relates to the Water Services etc. (Scotland) Bill (SP Bill 23) as introduced in the Scottish Parliament on 11 June 2004

the disconnection of a water supply and the procedure to be followed in the latter case (sections 14 to 17);

- provides new arrangements for determining Scottish Water’s charges, under which the Water Industry Commission will determine charge limits based on objectives set by Ministers, and Scottish Water will propose charges schemes within these limits (sections 18 and 19); and

- sets out definitions of “eligible premises”, for the purposes of retail competition, and of “public water supply system” and “public sewerage system” (sections 20 to 22).

- Part 3 of the Bill makes provision regarding coal mine water pollution, providing a statutory basis for the remediation programme carried out by the Coal Authority to tackle and prevent pollution (section 23).

- Part 4 of the Bill makes miscellaneous and general provision, including in relation to the offences created under the Bill and the procedure for exercising the order and regulation making powers provided under the Bill (sections 24 to 29).

3. The provisions in the Bill will provide a strong and highly transparent regulatory framework for the water industry in Scotland, improving understanding of charges and costs at all levels and securing the Scottish Water’s effective function at the lowest reasonable cost. This is in the interests of all customers. The new regulation arrangements will be made more accountable through an order under the Scotland Act which will work with the provisions in the Bill to provide a right for Scottish Water to appeal the decisions by the Water Industry Commission to the UK competition authorities, who have the expertise to rigorously examine the economic decisions made by the Commission.

4. The Executive consulted on the draft Water Services Bill between October 2003 and January 2004. In total 47 consultation responses were received, and a summary of these was placed in the Scottish Parliamentary Information Centre on 29 January 2004. The responses themselves may be viewed by the public in the Scottish Executive library.

5. Subsequently, the Finance Committee has completed its inquiry into the water industry and it published its Report on Scottish Water on 22 April 2004. Some of the Committee’s key findings, including calling for more transparency and accountability in the regulation of the industry, are addressed by the provisions of the Bill. In particular, the Committee’s Report recommended that an improved structure for the office of the Water Industry Commissioner was required, including non-executive membership, which could provide greater accountability and continuity for the industry, and that consideration should be given to the regulator taking certain decisions on the basis of advice from Ministers rather than the reverse. These changes are delivered in the Bill.

Background

Scottish Water

6. Scottish Water is responsible for providing all services on the public water and sewerage networks across Scotland. It was established as a public corporation by the Water Industry
This document relates to the Water Services etc. (Scotland) Bill (SP Bill 23) as introduced in the Scottish Parliament on 11 June 2004

(Scotland) Act 2002 and is accountable to the Scottish Ministers and through them to the Scottish Parliament for the provision of these services. Scottish Water supplies water services to over 95% of households and sewerage services to over 90% of households. The remainder are served by private water supplies and sewerage systems, which are the responsibility of their owners, not Scottish Water. Scottish Water also provides water and sewerage services to some 160,000 other premises that are not households.

Commitments

7. Scottish Ministers are committed to retaining Scottish Water in the public sector, a commitment confirmed in A Partnership for a Better Scotland in May 2003. Ministers have charged Scottish Water with the objective of achieving significant improvements in efficiency, to ease pressure on customer charges for the benefit of all water customers. They also require Scottish Water to continue contributing towards their public health and environmental protection objectives by ensuring an uninterrupted supply of wholesome drinking water, and the safe disposal of wastewater. Ministers are also committed to ensuring that water charging is on an equitable basis, securing social policy objectives. The forthcoming Principles of Charging consultation will consider how this should be achieved.

Regulatory framework

8. Scottish Water operates within a regulatory framework designed to safeguard public health and the environment and to promote the interests of customers. The framework’s main elements are:

- the Drinking Water Quality Regulator;
- the Scottish Environment Protection Agency;
- the Water Industry Commissioner for Scotland; and
- the Water Customer Consultation Panels.

Competition Act 1998

9. The possibility of competition on the public networks has increased since 2000, when the Competition Act 1998 came into force. The Competition Act includes prohibitions on agreements between businesses which have the object or effect of preventing, restricting or distorting competition; and on conduct by one or more businesses which amounts to the abuse of a dominant position.

10. These prohibitions affect Scottish Water in a number of ways. For example, the basic principle of competition legislation relating to “essential facilities” carries significant implications for Scottish Water. Where certain assets (such as water and sewerage pipe networks) are uneconomic to duplicate, but use of them is essential in order to compete effectively in a market, the owner of the assets may be required to provide competitors with access to them on an equitable basis. If it were demonstrated that such a position existed in a particular case, failure to allow such access could leave the owner open to the charge of abusing a dominant position. This opens up the possibility of being required to permit two types of competition in the water industry:
• **Common carriage** – where Scottish Water would use its system of water mains to carry water treated by a competitor’s customers, or use its sewers to carry wastewater from a competitor’s customers to the competitor’s treatment works, or both; and

• **Retail competition** – where Scottish Water would continue to have sole responsibility for physical treatment and distribution on the public networks. However, it would undertake these activities on behalf of the competitor, and the competitor rather than Scottish Water would have a direct commercial relationship with the ultimate consumer of the service.

11. Without express provision, the Competition Act 1998 might allow potential competitors to seek to enter the market in either of these ways, and if their challenges were successful, this would result in these types of competition irrespective of Ministers’ objectives and without effective regulation or a licensing system to manage the presence of competitors in the market. The Bill therefore makes provisions in relation to each potential type of competition, prohibiting common carriage for any customer, and prohibiting retail competition for household customers. The Bill then provides a licensing regime under which retail competition for business customers can develop, balanced with provisions to protect the interests of the generality of customers served by Scottish Water.

**DETAILED POLICY OBJECTIVES OF THE BILL**

**PART 1: WATER INDUSTRY COMMISSION FOR SCOTLAND**

*Policy*

12. The Bill provides for the office of the Water Industry Commissioner to be re-structured as a body corporate, the Water Industry Commission for Scotland. This is a change made in response to consultation on the draft Bill, and growing best practice on the structure of regulatory authorities. It is also in line with a recommendation in the Finance Committee’s recent Report on Scottish Water. The new provisions recognise the benefits in terms of accountability, transparency and continuity of moving from an individual regulator to a board structure with collective responsibility for decision-making. The Bill provides that all the functions currently vested in the Commissioner will be conferred on a small body of experts.

13. The Commission will comprise a Chairman, two to four other members, and a Chief Executive. Members will be experts who bring relevant specialist skills to the post, rather than representatives of stakeholder or customer groups. This is in recognition of the fact that the work of the Commission will be of a highly technical nature. A small, well-qualified Commission will be in the best position to make robust regulatory decisions which are in the interests of all customers. And the new provisions on charge determination make a clear separation between policy decisions, which are for Ministers, and technical economic decisions which the Commission should be best placed to take.

14. The new body corporate will operate as a non-departmental public body, in line with guidance on the establishment of public bodies, and regulated by the Commissioner for Public Appointments. The independence that this model provides will ensure that the Commission is able to carry out its technical, statutory functions at arm’s length from Ministers, as is appropriate for a regulatory body. At the same time the model maintains appropriate
accountability to Ministers and Parliament, in particular in respect of its financial management and administration.

15. A major new function for the Commission is charge determination, including determining maximum charge levels and approving Scottish Water’s charges schemes. This role is described in detail in paragraphs 59 to 71, and will place responsibility for these key decisions on the regulator, in the context of policy advice from Ministers. The provisions in the Bill will ensure that the appropriate economic expertise is brought to bear on charges, and also that the process is much more transparent and consultative. And to ensure that the Commission’s decisions in turn are subject to appropriate expert scrutiny, the Commission will be made accountable to the Competition Commission for its decisions on charging, which will be achieved through an order under the Scotland Act in the UK Parliament. These combined checks will ensure appropriate accountability for all regulatory decisions and a stronger process that is in the interests of all customers.

16. The creation of a Commission to take collective responsibility for the Commissioner’s functions is in line with the findings of a report by the Better Regulation Taskforce, an independent body which advises Government on regulation and its enforcement, which found that boards improved continuity and consistency of regulation, and provided greater experience and expertise to be brought to bear in regulatory decisions. The report goes on to recommend that all independent regulators should have boards, including both executive and non-executive members. It is also consistent with the restructuring, due to take place shortly, of the water regulator in England and Wales, Ofwat, into the Water Services Regulation Authority as provided for in the Water Act 2003.

Alternative approaches

17. It would have been possible, as consulted on, to continue the Commissioner’s role as an individual regulator. However, the Bill significantly increases the regulator’s role, in giving the regulator responsibility both to administer the licensing regime, and now, since consultation, to determine Scottish Water’s charges. Concerns at vesting too much responsibility in one individual were raised through consultation, and a similar recommendation in favour of non-executive members was raised in the Finance Committee’s Report. Given the powers the regulator will now exercise, and the best practice referred to earlier, the Executive is persuaded that it is important that the regulator is a body corporate.

18. Alternatives to the approach chosen in the Bill would have been to establish the Commission as another type of body, or to give its functions to an existing body.

19. Potential structures could have included an agency of the Scottish Executive, or a non-ministerial department. However, Ministers concluded that a non-departmental public body offered the desired balance of Ministerial accountability and regulatory independence which would be essential to the successful carrying out of the Commission’s functions.

20. For an existing body to take on the Commission’s functions it would have to have had expertise in economic regulation, and the function would have to sit well with its other functions. The forthcoming Water Services Regulation Authority in England and Wales offers the closest possible match. However, even this would not really be an appropriate body to take on the
functions of the current Commissioner, given the different structure of the water industry in England and Wales and their approach to competition in the industry. This means that the common features and potential for shared regulation are limited and the option of transferring the functions of the current Commissioner to another existing body has therefore not been pursued.

**Consultation**

21. In response to the proposal that the Commissioner be given authority to administer the licensing regime, a significant number of consultation respondents expressed concern over the large amount of power being vested in one individual. Some specifically suggested that the post be re-structured as a board, while others favoured some limitation on the powers of the individual, which the Commission will now provide. Some respondents also cited the recommendations of the Better Regulation Taskforce.

22. It is likely that the further extension of the Commissioner’s powers to determine Scottish Water’s charges would have added weight to the concerns of these respondents. The Executive has therefore responded directly to these views by re-structuring the office as a Commission.

**PART 2: PROVISION OF WATER AND SEWERAGE SERVICES**

**Prohibition on common carriage**

**Policy**

23. Competition in the form of common carriage (defined in paragraph 10) has the potential to bring benefits to customers through extending competition throughout water and sewerage service provision in Scotland. However, it also poses serious risks to public health and the environment.

24. Allowing third parties to add drinking water that they had treated to the public networks, or to draw wastewater from the public sewers for treatment, would involve them in the processes by which Scottish Water manages the infrastructure as a whole to ensure compliance with stringent drinking water and wastewater treatment regulations. This involvement would necessarily complicate these processes and introduce additional and ongoing risks. In the case of drinking water, there would be the primary risk to public health from the insertion of inadequately treated water. In addition common carriage would probably mean new suppliers tapping new sources of water and this could impact on effective water resource management. These risks could be managed by placing strict operating conditions on the third party, but they could not be eliminated. Consequently, there would be a greater likelihood of failure within the process.

25. Were such risks to be realised, the consequences could include contamination of the public water supply, interruption to the supply and damage to the public infrastructure – all of which would threaten public health. Similarly, on the wastewater side, there could be pollution, including sewage flooding, interruption to the supply and again damage to the public infrastructure, threatening public health and the environment.
This document relates to the Water Services etc. (Scotland) Bill (SP Bill 23) as introduced in the Scottish Parliament on 11 June 2004

26. The Executive has concluded that these risks to public health and the environment outweigh any foreseeable benefits that might arise from competition in treatment and carriage services. Therefore, in the interests of safeguarding public health and the environment, the Bill revises the regulatory framework to prohibit anyone other than Scottish Water from using the public networks to carry out the physical supply of water or sewerage services.

Alternative approaches

27. The alternative to prohibiting common carriage would be to allow Scottish Water’s competitors to add to the public networks drinking water they had treated, or to draw sewage for treatment from the public sewers. This would entail the risks described above and the Executive is not willing to potentially endanger public health and the environment in this manner. Because of the nature of common carriage even introducing limited common carriage, for example, for large business customers only, would give rise to the same public health and environmental risks given the use of the public networks to serve them.

Consultation

28. Consultation respondents were generally very supportive of the prohibition on common carriage on the grounds of protecting public health and the environment. Some respondents from the business sector considered that the prohibition should be re-assessed once the effects of limited retail competition had been analysed.

Prohibition on retail competition for households

Policy

29. Retail competition (defined in paragraph 10) for all customers would render unworkable the current arrangements whereby the local authorities bill the great majority of domestic customers for their water and sewerage charges alongside their council tax bills. This system contributes towards the achievement of Ministers’ social policy objectives. Crucially, the current arrangements link water and sewerage charges to the council tax band of a householder’s property. This link means that households occupying properties in council tax Band A pay two thirds of the charge paid by those in Band D and one third of the charge paid by those in Band H. In addition the council tax discounts available to particular households are applied to water and sewerage charges too: single adult households, and households including students, people with a disability or severe mental impairment, or carers, all qualify for discounts. Taken as a whole these arrangements provide that charges broadly reflect ability to pay, with those living in higher banded properties, who tend to be better off, paying more for their water and sewerage services than those in lower banded properties.

30. However, these arrangements are dependent not only on the current link to council tax bands, but also on the practice of the local authorities collecting the charges along with council tax payments.

31. Careful regulation of charge setting could enable the link between council tax bands and water charges to be retained, were parties other than the local authorities to bill households. However, we have concluded that there is no feasible means by which the range of discounts could be retained without local authority billing and collection. Consequently, there is a serious
risk that retail competition for households could mean new entrants to the market “cherry picking” high-banded properties, which pay relatively more for their water, leaving low-banded properties and those attracting discounts to be served by Scottish Water. This would reduce Scottish Water’s revenues, leaving it little option but to increase charges to those customers who remained with it.

32. In light of these very particular arrangements for charging, it is unlikely that competition would develop in a manner that would benefit all customers. Indeed, the expectation would be that low income and vulnerable households, such as single parents and single pensioners, would end up being worse off as they would lose the discounts they currently receive. Accordingly, the Executive has decided that the regulatory framework should prohibit retail competition in the household sector.

Alternative approaches

33. The alternative to prohibiting retail competition in the domestic sector, would be to allow other companies to carry out billing and collection functions for households. This would mean losing the linkages between the council tax billing system and water charges, with the results as described above. The Executive’s social policy objectives would thus be jeopardised, and on this basis it has been decided that domestic retail competition is not acceptable.

Consultation

34. Respondents were generally very supportive of the policy of prohibiting retail competition for the domestic sector, on the basis of protecting the current system of cross subsidies and discounts, which helps fulfil the Executive’s social policy objectives. The Executive will shortly consult on the principles of charging including affordability for different customer groups.

Licensed retail competition for the non-domestic sector

Policy

35. In securing Ministers’ public health, environmental protection and social policy objectives, the Bill provides two prohibitions, against common carriage, and against retail competition for household customers. However, on balance Ministers have concluded that these grounds do not provide justification for prohibiting retail competition for non-household customers. The 160,000 non-household premises served by Scottish Water are directly billed by Scottish Water, and if competition did develop in this sector, it could be to the benefit on these customers. Such competition would mean Scottish Water would become the wholesaler of water and sewerage services to new entrants to the market, who would retail these services to the end user, providing services such as meter reading, billing and collecting charges.

36. Providing wholesale services will require Scottish Water to improve the transparency and accuracy with which it accounts for the different costs of its business. This will make it easier for the Water Industry Commission and retailers to measure Scottish Water’s progress in delivering efficiencies and for Scottish Water itself to identify the scope for greater cost effectiveness. Thus the development of competition in one part of the business could be expected to provide an additional spur to efficiency beyond that provided by the current regulatory arrangements. This
This document relates to the Water Services etc. (Scotland) Bill (SP Bill 23) as introduced in the Scottish Parliament on 11 June 2004

would benefit all customers. Additional benefits might include billing arrangements better suited to the needs of particular non-household customers.

37. However, it is important to ensure that those who gain most from competition do not do so at the expense of other customers. Accordingly, the Bill contains provisions to establish a regime to license the providers of retail services to deliver that outcome. In particular the Bill and the licensing regime will ensure that customers requiring similar services anywhere in Scotland should pay similar charges. This geographic harmonisation will remove any incentive for providers to cherry-pick customers who are technically cheaper for Scottish Water to serve due to their location.

38. The Executive proposes two types of licence:
   - a water services retail licence – whose purpose is to establish a legal right for the holder of such a licence to enter into contractual agreements with non-domestic customers on the public networks, for the provision of water services.
   - a sewerage services retail licence – whose purpose is to establish a legal right for the holder of such a licence to enter into contractual agreements with non-domestic customers on the public networks, for the provision of sewerage services. This licence will cover trade effluent services, though it will not affect Scottish Water’s responsibility for monitoring compliance with trade effluent consents and agreements.

39. Only licence holders will be entitled to become wholesale customers and to offer retail services to customers on the public networks. It will be possible for a retailer to hold one or other or both licences depending on the services that they wish to offer to their customers.

40. The licensing regime is a key element in providing certainty in the industry. Through careful regulation, new entrants to the market will be required to contribute fairly to Scottish Water’s costs, so that Scottish Water’s finances are safeguarded. The Commission will have a duty to facilitate the orderly development of the market, including, for example, ensuring effective arrangements are established to ensure that transfer of data when customers switch supplier is handled efficiently and responsibly.

Alternative approaches

41. Given the scope of the Competition Act 1998, the alternative to providing a regime to support retail competition among non-household customers would either be to seek a specific prohibition of retail competition, or to let new entrants into the market without being regulated or subject to any licence conditions. Competition policy is reserved to Westminster, and Ministers have concluded, as set out above, that there are not public health, environmental protection or social policy objectives to justify a prohibition on other grounds. That leaves the alternative of unlicensed competition. This would offer no system to ensure retailers paid fair charges, and would risk them negotiating charges that disadvantaged other customers. For example, a retailer might decide to serve only customers whose premises were situated close to treatment works, and who were therefore technically cheaper to serve. The retailer could then try to use this to justify paying a lower wholesale price to Scottish Water. The licensing regime is therefore needed to protect geographic harmonisation of charges. The Executive recognises the desire for
keener charge levels, but believes that these should be based on improved efficiency within Scottish Water and that these benefits should be available to all customers, household as well as non-household. Establishing a licensing regime will ensure that retailers and their customers contribute fairly and proportionately to the costs of maintaining the whole of the public networks on which they will still rely for the service. This is a key aim of the licensing regime.

**Consultation**

42. The proposal to introduce licensed retail competition met with a more mixed reaction from consultation respondents than the two prohibitions. Opinion was divided as to whether any competition at all should be allowed in the water industry, and among those who were in favour of competition, there was a wide range of views as to whether the proposed regime was too restrictive or not restrictive enough.

**Establishing a licensing regime**

**Policy**

43. The purpose of the licensing regime is to ensure equality of treatment for all customers served by the public networks i.e. to ensure that, with the introduction of competition, retailers pay a fair wholesale price which neither disadvantages businesses or domestic customers. The licensing regime will be established and operated by the Water Industry Commission as the economic and customer service regulator of Scottish Water. The Bill gives the Commission duties to administer the licensing regime, granting licences and monitoring compliance with licence conditions, and confers on it powers to obtain information and charge fees and to facilitate the orderly opening of the market.

44. At present the Commissioner acts on behalf of all categories of Scottish Water’s customers. To ensure that the Commission acts in the interests of all end users of the public networks, it is proposed that its general function of promoting the interests of Scottish Water’s customers should be extended to include the interests of retailers’ customers. This duty will not extend to the Commission being involved in regulating the charges set by new entrants for their customers, which is a matter to be settled between supplier and customer in a competitive market. However, it will cover levels of service provided by new entrants insofar as these might be specified in licences. An important part of the Commission’s new role will be to ensure that new entrants are capable of providing the level of service that they propose in their application for a licence and that subsequently they do provide that service consistently in accordance with their licence.

45. The Bill places a duty on the Commission to monitor compliance with the terms and conditions of licences and to take any action necessary to ensure compliance. Licence conditions will ensure that retailers meet their obligations to contribute towards the costs of maintaining the public networks. In granting licences the Commission will be required to satisfy itself that the applicant has the financial strength and the operational and managerial capacity to meet their licence conditions as a retail supplier.

46. It is proposed that the Commission will administer the licensing regime on the basis of regulations made by Ministers. The regulations will be the subject of consultation before being given effect in secondary legislation. Their purpose will be to ensure that there is a transparent,
fair and proportionate process by which the Commission considers licence applications, grants licences and subsequently monitors compliance with licence conditions.

**Alternative approaches**

47. As the economic and customer service regulator for Scottish Water, the Commission is the obvious choice of authority to administer the regulation of new entrants to the market. Placing this responsibility elsewhere would have increased the risk that customers who take advantage of retail competition would receive less protection than those who remain with Scottish Water, or than household customers. And not establishing a licensing regime would fail to provide the certainty required to meet the Executive’s public health and social policy objectives.

**Consultation**

48. Most respondents who accepted that there should be some form of competition in the industry were content for the Commissioner to administer the licensing regime. However, a significant number felt that too much power was being vested in a single person, and emphasised the importance of making the Commissioner’s decision making transparent and accountable. These concerns have been addressed by re-structuring the Water Industry Commissioner as a body corporate, as explained above.

**Orderly opening of the market**

**Policy**

49. The Bill confers a duty on the Commission to exercise its licensing functions in such a way as to ensure that the interests of all customers served by the public networks continue to be safeguarded. In particular it provides a duty on the Commission to ensure that the new regime operates in a way that is not to the detriment of water customers as a whole. This will be done by protecting Scottish Water since, if Scottish Water suffers financial losses as a result of the retail market, any shortfall in its income will need to be made up through higher customer charges. Therefore it is in the interests of all charge payers that the regime develops smoothly leaving Scottish Water in a secure financial position. This will mean, for example, setting licence conditions to protect Scottish Water from any risks to its finances arising from competition, by stipulating strict payment conditions for new entrants, and avoiding any unforeseen and potentially destabilising effects on Scottish Water and the industry as a whole.

50. It also provides a duty for the Commission to exercise its licensing functions to secure the participation of retailers in an orderly manner. To enable it to discharge this duty, the Commission will be able to direct Scottish Water or retailers (actual or prospective) to carry out such steps as are necessary to secure such participation. This may include requiring the provision or exchange of information so that there are, for example, suitable means of handling customer data. This is to address specific concerns, due in part to the experience of the energy sector, about the way in which this data is transferred when a customer switches between retailers. The Commission is authorised to take the initiative in this area if it becomes necessary. It will also ensure appropriate use of customer data, addressing concerns over privacy raised by consultation respondents. Careful regulation in this area is an important part of minimising the uncertainty surrounding limited competition.
**Alternative approaches**

51. An alternative way of ensuring the orderly opening of the market would have been to phase the introduction of competition through the use of thresholds, similar to those which have been imposed in England and Wales, where only premises using over 50 megalitres of water a year are eligible for competition. However, use of thresholds is primarily intended to ease the transition to common carriage, which raises practical issues for the incumbent water provider about how it manages the impact of new entrants gaining access to its infrastructure. Common carriage can also lead to the problem of “stranded assets”, that is, treatment works which the incumbent no longer requires because new entrants have displaced a significant part of its treatment activity in a short space of time. Neither of these issues arise in Scotland since the Bill prohibits common carriage, and therefore the use of thresholds was not considered to be a necessary or appropriate means of phasing the introduction of competition. Instead the Commission has the power to take action required to ensure orderly opening of the market, as set out above.

**Consultation**

52. A majority of respondents who expressed a clear view on this issue were in favour of some form of transitional thresholds. This view was generally based on concerns about the unknown impact of competition on Scottish Water, and about potential destabilisation. The duties of the Commission described above have been introduced into the Bill in order to address these concerns.

53. Those respondents who argued against the use of transitional thresholds did so on the basis that they would stifle the market before it had had the chance to develop, and would make it less attractive to new entrants, to the detriment of customers accessing the benefits of competition.

54. The provisions in the Bill use strong powers to set licence conditions to balance the security gained by prohibiting common carriage with the remaining risks to businesses from retail competition for business customers; and give the Commission all necessary powers to ensure that the market does open in an orderly manner, but without limiting the sections of the market open for new entrants to serve.

**Separation of Scottish Water**

**Policy**

55. The Bill confers on Scottish Ministers powers to direct Scottish Water to establish a subsidiary, with a view to ensuring the separation of its statutory and licensed activities. The Executive does not consider that Scottish Water should be subject to the licensing regime in so far as it discharges its core functions as the physical provider of water and sewerage services. Scottish Water is bound by statute to perform these functions, usually to prescribed standards, and it is not desirable for these to be additionally subject to licence conditions. On the other hand, Scottish Water’s retail activities must not be placed in an advantageous or disadvantageous position in relation to other retailers. In terms of the provision of retail services, Scottish Water will be in direct competition with other retailers, and must not use or be thought to be using, its position as sole provider of wholesale services, to put its competitors at a disadvantage.
56. To achieve these aims, Ministers are being given powers to require Scottish Water to establish a separate, wholly owned, retail subsidiary to be responsible for all retail activities. Scottish Water’s wholesale and retail activities will be accounted for separately, and the subsidiary will be treated in the same way as other retailers for the purposes of the licensing regime. The retail arm will be subject to the same regulation as other retailers, and treated by Scottish Water’s wholesale business in the same way as other retailers.

Alternative approaches

57. If Scottish Water were to enter the retail market without separating its retail and wholesale activities, it is likely that other retailers would feel unfairly disadvantaged by Scottish Water’s dual position as retailer and wholesale provider to other retailers. An alternative would have been to restrict Scottish Water from competing in the retail market for business customers. However, without being able to predict how the market will develop or how quickly, this option seems to carry unacceptable risk and uncertainty.

Consultation

58. Most respondents expressing a clear view on this subject were in favour of the separation of Scottish Water into wholesale and retail arms. They were generally very concerned that a genuine separation should take place, including separation of accounts. Some felt that even with these provisions, Scottish Water retail would still retain an advantage over other retailers, and in response to these concerns more explicit provision to ensure the full legal separation of Scottish Water’s retail subsidiary has been made in the Bill. Some respondents felt that this separation was not desirable, because of the disruption to Scottish Water’s core business and uncertainty for staff. However provisions have been included in the Bill to ensure that the terms and conditions of all employees transferring are explicitly preserved; as well as ensuring that the appropriate provision for rights (including contractual arrangements with customers) and liabilities to transfer to the subsidiary. This is intended to make any transfer as straightforward as possible.

Charge determination

Policy

59. The Bill establishes new arrangements with regard to the way in which Scottish Water’s charges are set. These give the Commission new authority to set charges which, as described in more detail below, will made be subject to a right of appeal by Scottish Water to the Competition Commission. In discharging these new charge setting functions, the Commission will be required to operate within a policy framework set by Scottish Ministers.

60. Under the new arrangements, Scottish Ministers will retain full policy control over Scottish Water’s functions. They will determine the level to which Scottish Water is to be required to perform its statutory duties where this is a matter of discretion. Ministers will also be able to stipulate additional functions or objectives for Scottish Water, which are non-statutory, to achieve wider policy objectives. For example, Ministers will decide on the principles of charging to which the Commission will be required to adhere when determining charges. This gives Ministers the power, for example, to provide for reduced charges for particular groups of customers, or to stipulate the proportion of charges that should be based on volumetric or fixed
elements of costs. This role will enable Ministers to give effect to the outcomes of the forthcoming consultation on the Principles of Charging, and any other future policy decisions.

61. Within this policy framework the Commission is first required to assess the total revenue that Scottish Water needs, based on the principle that the revenue raised by the scheme of charges, when taken with the borrowing and grants available to Scottish Water from Ministers, should never be less than sufficient for the purpose of enabling Scottish Water to perform its core functions effectively, and fulfil any other objectives set by Ministers. In calculating this, the Commission must take account of all circumstances which might have a bearing, either positive or negative, on Scottish Water’s ability to meet its obligations.

62. Having had regard to these factors, the Commission will determine maximum charge limits for Scottish Water’s charges for its core functions. These charge limits will be based on the objectives set by Ministers, including the principle that customers are to be considered, and charged, as users of a national as opposed to a local service. This means charges will reflect the cost to Scottish Water of maintaining its whole infrastructure across the country, irrespective of the actual cost of serving individual customers which will vary, for example, with distance from treatment works.

63. The Bill requires the Commission to firstly consult on the process by which it carries out charge determination. The Commission is then to make and publish a draft determination and to take into account the representations received. Following this consultation the Commission will make a final determination of charge limits. Similarly to the current set up, it is expected that a charge determination will be made for a medium term period, for example, the first one is expected to cover charges in 2006-2010. However the Bill also provides for determinations to be reviewed in advance of the date set for the next determination, if there is a substantial change in circumstances meaning that the amount of revenue Scottish Water requires to carry out its core functions increases or decreases significantly. Once the determination has set maximum limits for Scottish Water’s charges, Scottish Water is required to propose a detailed charges scheme, which must adhere to the maximum charges set out in the Commission’s determination. It is expected that Scottish Water will be asked to propose charges schemes on an annual basis.

64. An important feature of the new arrangements for charge setting is that Scottish Water will no longer have discretion to make agreements with specific customers about the charges levied on them. Instead, all charges must be made by reference to a charges scheme except for departures from the charges schemes which will require to be specifically authorised by the Commission on the basis that the charge-payer has taken action which reduces the cost to Scottish Water of serving them. The Bill makes specific provision for existing agreements to be continued until they expire, and provision that they may not be renewed or extended.

65. As mentioned earlier, an important component of the new charging regime is to balance the Commission’s charge determination powers with a right of appeal to the Competition Commission. Under the current set up, the Commissioner advises Ministers on charge setting, and when the Commissioner’s advice conflicts with Scottish Water’s view, Ministers have to decide charges. This is not ideal given that Ministers and the Executive do not have, nor would it make sense for them to have, the technical economic expertise to make a robust and objective assessment of the Commissioner’s advice and determine whether to follow it or modify it. And
as Scottish Water’s owner, Ministers also have a potential conflict of interest. There is therefore a clear case for excluding Ministers from this process, and providing more effective accountability for the Water Industry Commission in its decision-making.

66. The Competition Commission is a UK body with the technical, economic and legal expertise to adjudicate in disputes between Scottish Water and the Commission. Their involvement will ensure that the charge setting process, carried out in the knowledge of a possible referral to the Competition Commission, is robust and transparent, and if a case is referred to them, their decision will be binding.

67. This role for the Competition Commission has been agreed with the Commission and the Secretary of State for Trade and Industry. Because matters relating to the Competition Commission are reserved under the Scotland Act, Scottish Water’s right of appeal to the Competition Commission will be established by way of an Order being made under section 104 of the Scotland Act 1998. This will be put in place as soon as possible after enactment of the Bill.

Alternative approaches

68. The new arrangements for the setting of water charges are fundamentally different to the current situation, where the Commissioner does not have the power to actually set charges, but simply advises Scottish Ministers on charges, albeit that his advice is detailed and based on an assessment of how efficiently Scottish Water can perform its functions. Currently Ministers make a formal response to the Commissioner’s advice on charges, and in the light of that response, Scottish Water draws up a charges scheme. The Commissioner must approve this scheme, but if he and Scottish Water cannot agree the terms of the scheme, it falls to Ministers to determine details of the charges scheme. This leaves Ministers in the position of either having to duplicate the expertise and experience that the Commissioner and his staff possess, or being unable to place his advice under expert or independent scrutiny.

69. The alternative to Scottish Water losing its right to make agreements would be to continue to allow them to do so; however this would not be consistent with the principle of harmonisation of charges. For example, if customers who cost least to serve ask for and are granted a lower price for services, it undermines the wholesale price being offered to other customers whose charges must rise in consequence. Permitting special agreements is contrary to the principle of harmonisation which the Bill is intended to enshrine. Therefore the Bill provides that current special agreements will not be renewed or extended. Instead it provides for new departures from charges schemes to be permitted by the Water Industry Commission where the customer in question has taken action to reduce the cost to Scottish Water of serving them.

Consultation

70. The provisions of the Bill establishing the new charging regime have been added since the formal consultation, but respond to concerns about transparency and accountability, including those raised in the Finance Committee’s report into the water industry. The Bill aims to provide the independent regulation and transparency which the Finance Committee recommended. In strengthening the mechanism governing the regulation of charges the Bill responds to concerns raised in the consultation about affordability of water charges and
efficiencies to be achieved by Scottish Water. The issue of affordability has been raised by various parties in different settings, and will be further addressed by the Executive’s forthcoming consultation on the principles of charging.

71. These provisions have also been discussed with Scottish Water and the Commissioner; and with the Department for Trade and Industry and Ofwat, with regard to the right of appeal to the Competition Commission for Scottish Water.

PART 3: COAL AUTHORITY

Policy

72. Coal mining activities in Scotland extend throughout the central belt, and are shown in the map below. There are currently over thirty discharges from abandoned coal mines in Scotland affecting the water environment. There is also the threat of rising mine water in some of the more recently closed collieries where discharges have not yet occurred but may do so unless preventative action is taken. The Coal Authority has an ongoing remediation programme to clear up or prevent pollution of the water environment from these coal mine discharges. The programme has been run on a non-statutory basis and receives funding from the Department of Trade and Industry. The high priority that the UK Government places on this work reflects, amongst other things, commitments made by the UK to the European Commission in the course of negotiations to end infraction proceedings brought against the UK for non-application of the Dangerous Substances Directive. In carrying out the work, the Coal Authority has developed important relationships with the Scottish Environment Protection Agency (SEPA) through a formal Memorandum of Understanding, given the latter’s existing powers under environmental legislation.

![Map of Coal Mining areas in Scotland](image)

*Figure 1: Map of Coal Mining areas in Scotland (shown in darker shade)*

73. Notwithstanding the Memorandum of Understanding, there has for some time been a concern at UK level that the Authority's mine water programme did not have specific statutory basis, particularly where the Authority is unable to gain access to land in order to carry out investigative work or where it cannot acquire land by agreement for its remediation works. To date the Authority's work in Scotland has been taken forward based on the "Strathclyde
Commitment", given during the passage of the Coal Industry Act 1994, that the Authority would "go beyond the minimum standards of environmental responsibility ... set by its legal duties in these areas and ... seek the best environmental result which can be secured from the use of the resources available to it for these purposes". However, the Coal Authority’s mine water programme is now long running and incurring increasing expenditure, and is likely to require to be transferred to a successor body in due course. The Water Act 2003 therefore placed it on a more secure statutory basis in England and Wales, and to gain these benefits and for consistency and coherence, similar provision is proposed for Scotland in this Bill.

Alternative approaches

74. The proposals in the Bill were developed through negotiations between the Department of Trade and Industry and the Coal Authority. They take account of SEPA’s views, and reflect provisions that have already been made in the Water Act 2003 for England and Wales.

75. Three alternative options have been considered: for the Coal Authority's remediation work in Scotland to continue as at present; to enact legislation for Great Britain in a Westminster Bill; and for SEPA to use its powers of entry and compulsory purchase on behalf of the Coal Authority. The Executive rejects these approaches.

76. For the Coal Authority's programme of remediation work in Scotland to remain without legislative certainty, when primary legislation has been enacted for its operations in England and Wales, would create incoherence and inconsistency of approach in its functions. There are cases in Scotland where the Authority has been unable to gain access to land to carry out investigative work or where it cannot acquire land by agreement for its remediation work. In these cases, without powers of entry and compulsory purchase, it, at worst, runs the risk of being unable to prevent water pollution incidents; for it to be unable to meet EC legislative obligations e.g. under the Dangerous Substances Directive; and for the DTI funding to be reallocated to other works, not necessarily in Scotland, in the remediation programme.

77. Given that the purpose of the powers proposed in the Water Services etc. Bill concern the control of pollution, which, being an environmental issue, is devolved, it is considered more appropriate to enact the proposed powers through this Bill rather than through a Westminster Bill. The DTI has indicated its agreement in principle to the conferral of pollution control powers on the Authority in Scotland through this Bill.

78. SEPA has powers to deal with the pollution of controlled waters which include remedial powers to deal with contaminated land, including from abandoned mines, result in the pollution of controlled waters. These include powers of access and compulsory purchase. It would, however, be inappropriate for SEPA to use these powers on behalf of the Coal Authority to achieve the latter's mine water remediation work. The use of the access and the ownership of the land would in these circumstances be SEPA's responsibility, and if the Coal Authority's operations were to lead to a pollution incident, it would compromise SEPA's responsibilities to consent and prevent discharges.

79. The Memorandum of Understanding, will continue to provide a mechanism for cooperation between the two organisations to tackle coal mining discharges and for ensuring that SEPA is kept fully informed of the Coal Authority's activities. However, the Coal Authority
will continue to be unable to progress remediation work in Scotland where it is not able to gain access to land, or to acquire land, by agreement. While SEPA has powers of access and compulsory purchase for environmental purposes, it would be inappropriate for it to use these powers on behalf of the Coal Authority for the reasons given above.

Consultation

80. Respondents broadly accepted the proposal to introduce powers for the Coal Authority to enter and compulsorily acquire land in order to take action to prevent environmental damage from abandoned coal mines.

EFFECTS ON EQUAL OPPORTUNITIES, HUMAN RIGHTS, ISLAND COMMUNITIES, LOCAL GOVERNMENT, SUSTAINABLE DEVELOPMENT ETC.

Equal opportunities

81. The Bill’s provisions are not discriminatory on the basis of gender, race, age, disability, marital status, religion or sexual orientation. The possible impact of the Bill on people with particular needs, including those with a disability, has been considered, and this contributed to the conclusion that retail competition should be prohibited in the domestic sector to achieve the Executive’s social policy objectives (see paragraphs 29 to 34).

82. The Bill should not be considered in isolation from existing statutory obligations in relation to equal opportunities. Public authorities have relevant statutory obligations under the Race Relations Act 1976, the Sex Discrimination Act 1975 and the Disability Discrimination Act 1995. All three Acts make discrimination in service provision unlawful. The Race Relations Act also places a general duty on public authorities to work towards the elimination of unlawful discrimination and promote equality of opportunity and good relations between people of different racial groups. The Commission for Racial Equality produces codes of practice to provide practical guidance to public authorities on how to fulfil that duty. The Water Industry Commission will be required to carry out all its functions in accordance with this legislation.

83. Equality issues could arise in relation to the way in which the Commission carries out its duties to publicly consult on its draft charge determinations. It will need to ensure that these consultations are open to all equality groups.

Human rights

84. The Executive is satisfied that the provisions of the Bill are compatible with the European Convention on Human Rights (ECHR). Particular attention has been paid both at policy development and drafting stages to the necessity of ensuring ECHR compliance.

85. In particular, the Bill respects the principle of peaceful enjoyment of property under Article 1 of Protocol 1 ECHR so far as consistent with the wider public interest in the regulation of public water and sewerage services (Parts 1 and 2), and the protection of the environment (Part 3 of the Bill). Controls over the use of property are no more than is necessary to protect those public interests. Enforcement powers in relation to the licensing of water and sewerage
service providers are proportionate to the need to safeguard the public interest in relation to the new licensing system (sections 6 to 11 of the Bill) and to protect the environment (Part 3 of the Bill). They are also compatible with Article 8 (right to a family life). The retail licensing and enforcement provisions the Bill, which are underpinned by appeal provisions, also respect the right to a fair hearing in Article 6 ECHR in so far as they give rise to any determination of civil rights and obligations.

**Island communities**

86. The Bill is designed to safeguard public health and the environment across the whole of Scotland, and will not have any disproportionate effect on island communities. The new regime for setting water services charges for all customers will ensure that all customers within a certain group will pay harmonised charges, and all customers will contribute to the cost of maintaining the infrastructure across the whole country. This is irrespective of the actual cost of serving any particular customer. If the cost of serving individual customers were to be taken into account then more rural areas would incur higher costs than urban ones and specific provision against this is made new section 29D of the Water Industry (Scotland) Act 2002 as inserted by section 18 of the Bill. By virtue of that Act, Scottish Water is already under a duty in exercising its functions to have regard to the interests of all its customers, especially those in rural or remote areas.

87. The provisions in the Bill only relate to customers served by the public water and sewerage networks. In that island communities are less likely to be on the public networks, they are less likely to be affected by, including sharing in any benefits from, these provisions.

**Local government**

88. The Bill will not affect the current arrangements whereby local authorities will continue to carry out domestic billing functions on behalf of Scottish Water, in order to safeguard the Executive’s social policy objectives. In their position as water customers, local authorities will be affected in the same way as all other non-household customers and will enjoy the benefits of retail competition if the market develops.

**Sustainable development**

89. In exercising all its functions, including those conferred on it by virtue of this Bill, Scottish Water is under a duty to act in the way best calculated to contribute to the achievement of sustainable development. Sustainable development can be understood in terms of economic, environmental and social impacts and these are considered separately below.

**Economic**

90. The Bill provides for competition in retail services, for the non-domestic sector. Establishing a licensing regime will promote the orderly development of the market, providing choice for customers, and encouraging efficiency, keener prices, greater customer responsiveness, innovation and improved standards in retail providers, all of which should result in economic benefits to businesses across Scotland.
91. The licensing of competition will ensure that this partial opening of the market does not have a detrimental effect on the finances of Scottish Water, which could have resulted in higher charges than necessary for domestic customers; an economic impact which the Executive was keen to avoid.

92. The new regime of charge determination will benefit both retailers and customers generally by ensuring that charges are set in a transparent manner by an expert board, and are kept to the minimum necessary to ensure Scottish Water is able to carry out its functions effectively.

Environmental

93. The prohibition on common carriage introduced by the Bill is intended to protect the environment by avoiding situations where anyone other than Scottish Water introduces water into, or draws sewage from, the public networks. Involving others in the process of managing the infrastructure would increase the risk of accidents occurring, and of non-compliance with drinking water and wastewater treatment regulations. Errors in the use of the water and sewerage networks could potentially result in damage to the environment through pollution and flooding, as well as contamination of the public water supply on the public health side, and damage to the infrastructure. The Executive considers that these environmental and public health risks require the prohibition on common carriage provided through the Bill.

94. In terms of resource management, a key element of sustainable development, common carriage would probably mean tapping new sources of water, which could have a negative impact on effective water resource management. The water and sewerage networks are also a valuable resource, albeit of a different kind than the water itself. Scottish Water’s extensive current investment programme is focussed on maintaining these resources in a sustainable manner. The licensing regime will ensure that Scottish Water continues to be sufficiently funded to meet its statutory obligations and Ministers’ wider policy objectives.

95. The coal mine water pollution provisions in Part 3 of the Bill will put the Coal Authority’s remediation programme on a secure statutory footing and reduce and prevent harmful pollution.

Social

96. The provisions in the Bill prohibiting retail competition in the domestic sector are intended to protect the Executive’s social policy objectives. Currently local authorities carry out billing functions on behalf of Scottish Water. Allowing anyone else to perform this role, would necessarily mean losing the linkage between water charges and council tax, including the taking into account of the discounts which form part of the council tax billing system (as explained more fully in paragraphs 29 to 34 above). This would be at odds with the Executive’s social policy, as the expectation would be that low income and vulnerable households such as single parents and single pensioners, would end up being worse off as they would lose the discounts available to them under the current system. Furthermore, there is a risk that new entrants to the market would “cherry pick” high banded properties, leaving the less profitable low banded properties to be served by Scottish Water. This would not benefit customers generally, as Scottish Water’s revenues would be reduced, leaving it little option but to increase charges to
those customers who remained with it. The Bill therefore aims to avoid socially unacceptable consequences, by prohibiting competition in the domestic sector.

97. As part of the new charging regime, the Bill provides for charge determinations to be on the basis of objectives set by Ministers. Ministers are given wide powers to set these objectives, which will allow them to specify the proportions of charges different categories of charge payers should fund, the ability to link charges to council tax liability, and to make separate provision for different categories of person. This would allow Ministers to make to maintain particular cross subsidies between groups of customers, or provide reduced charges to some customers in order to meet specific social policy objectives.