

SCOTTISH WATER'S PERFORMANCE 2021-22

March 2023

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About this document

This report sets out WICS' assessment of Scottish Water's performance in financial year 2021-22, the first year of the new regulatory control period 2021-27.

Alongside this report, WICS has also published a letter highlighting WICS' concerns about the quality and completeness of Scottish Water's reporting and slower than expected progress in the key areas set out in the Final Determination¹.

The report covers:

- an overview of Scottish Water's performance;
- Scottish Water's expenditure in 2021-22; and
- what Scottish Water delivered for that expenditure in 2021-22 in terms of levels of service to customers and outcomes for the environment.

¹ See the accompanying cover note and letter WICS (2022), "Scottish Water's reporting quality and completeness".

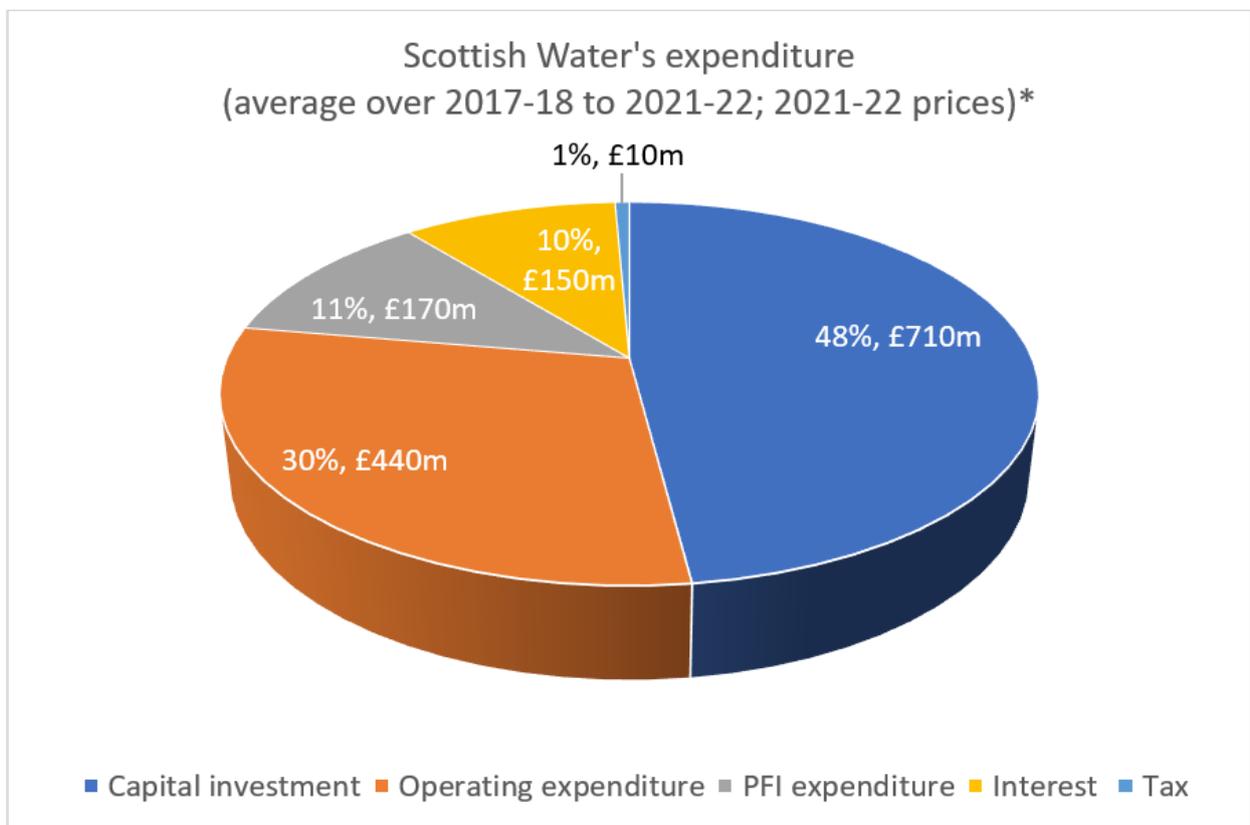
Overview of performance

WICS is pleased to confirm that Scottish Water has broadly maintained its performance during 2020-21 and 2021-22. That said, there does appear to be some slippage in the delivery of its investment programme. This slippage is clear when reported expenditure is compared to the allowed for investment in the Final Determination. WICS and other industry stakeholders are monitoring performance in this area closely.

Scottish Water's expenditure in 2021-22²

Scottish Water spends around £1.5 Bn each year. Figure 1 shows the breakdown of Scottish Water expenditure by category.³

Figure 1: Scottish Water's expenditure



This section covers each area of expenditure in turn.

Capital investment

The Final Determination for the Strategic Review of Charges 2021-27 (SRC2021-27) recognised that investment would need to increase significantly over the next two decades if the industry is to

² The figures in this report are presented in outturn prices, unless stated otherwise.

³ PFI expenditure relates to payments to contractors that provide wastewater treatment and sludge disposal on behalf of Scottish Water through legacy Private Finance Initiatives (PFI) contracts. Expenditure is rounded to the nearest £10m.

maintain levels of service in the face of a changing climate (the adaptation challenge). Moreover, the Scottish Government has an ambitious net zero emissions target which it requires Scottish Water to meet by 2040 (the mitigation challenge). Achieving this target will require a different approach to investing. The Final Determination therefore allowed Scottish Water just over £4.5 Billion in 2017-18 prices – an uplift of around 30% compared to the previous regulatory control period.

After the Final Determination was published, Scottish Water redefined operating expenditure to reflect improvements to its systems of cost capture. This change has the effect of reducing the allowed for operating expenditure by £50m a year and increasing the allowed for investment to £4.8 Billion in 2017-18 prices. There were also further changes to the funds available for investment in the Final Determination, as set out in Figure 2.⁴

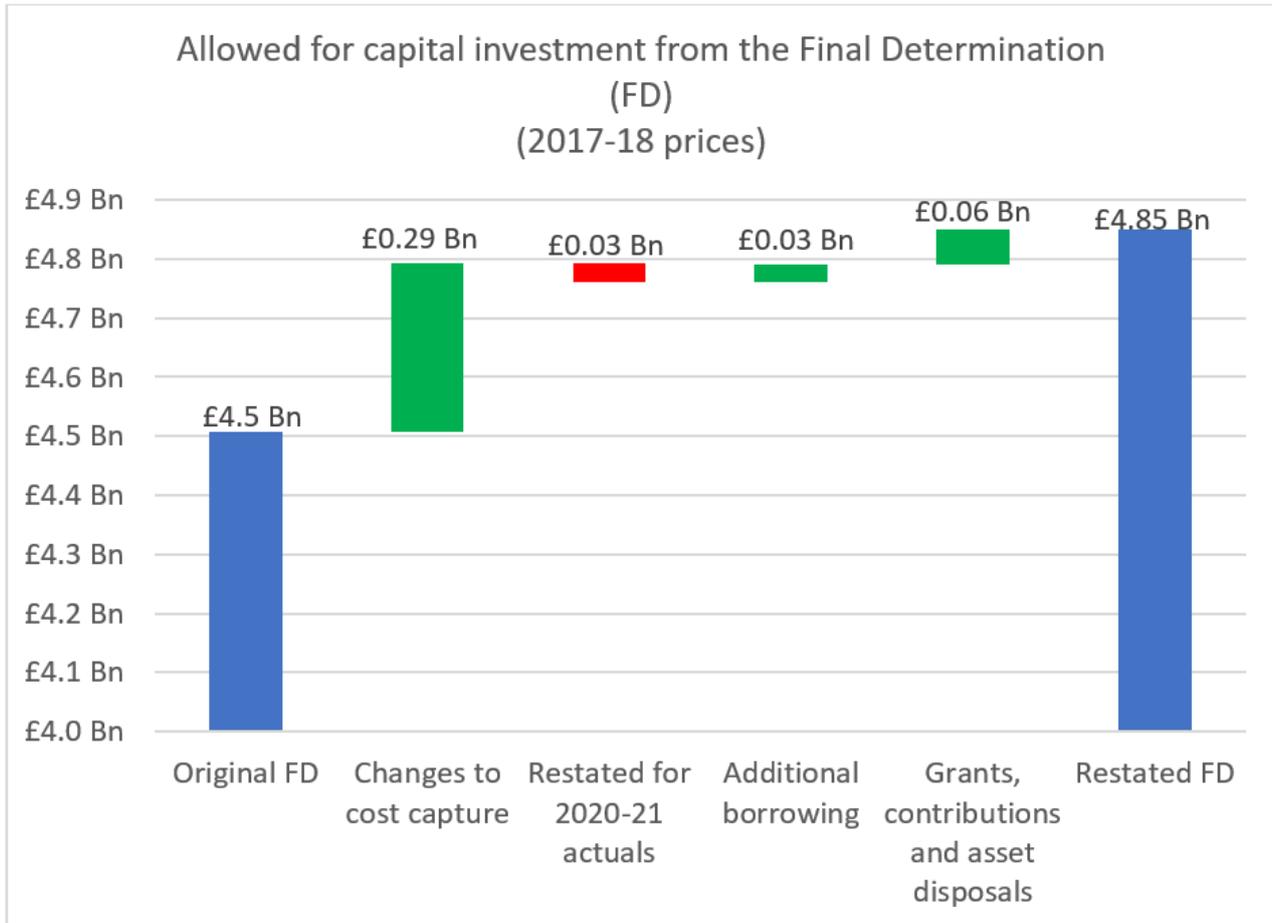
⁴ These changes reflect an updating for the 2020-21 closing financial position and the net new debt that the regulated activities will receive over the period and include grants and capital contributions and asset disposals.

The Final Determination, published in December 2020, used Scottish Water's forecasts for the closing revenue and cash balance for 2020-21. The Final Determination also included assumptions for the financial year average cost inflation over 2020-21.

Additional borrowing is the result of the acquisition of Aberdeen Environmental Services (AES) Ltd in the regulatory control period 2015-21. At the time of the acquisition, the external bank debt on AES's balance sheet had to be counted within Scottish Water's borrowing. This transaction reduced the effective new borrowing from the Scottish Government in that regulatory control period. Scottish Water repaid the external bank debt in the current regulatory control period, allowing it to draw down additional borrowing from Government. Further information is available from Scottish Water (2022) 'Interim report and accounts for the six months to 30 September 2022' December, p.30.

The grants and capital contributions and receipts from asset disposals were not included in the Final Determination. However, given that Scottish Water reports capital investment inclusive of grants and capital contributions, the allowed for investment in the Final Determination is restated to include these items. The forecast for grants and contributions over the regulatory control period 2021-27 is based on Scottish Water's own forecasts from its financial model (Financial Model v12.8).

Figure 2: Allowed for investment over the regulatory control period 2021-27



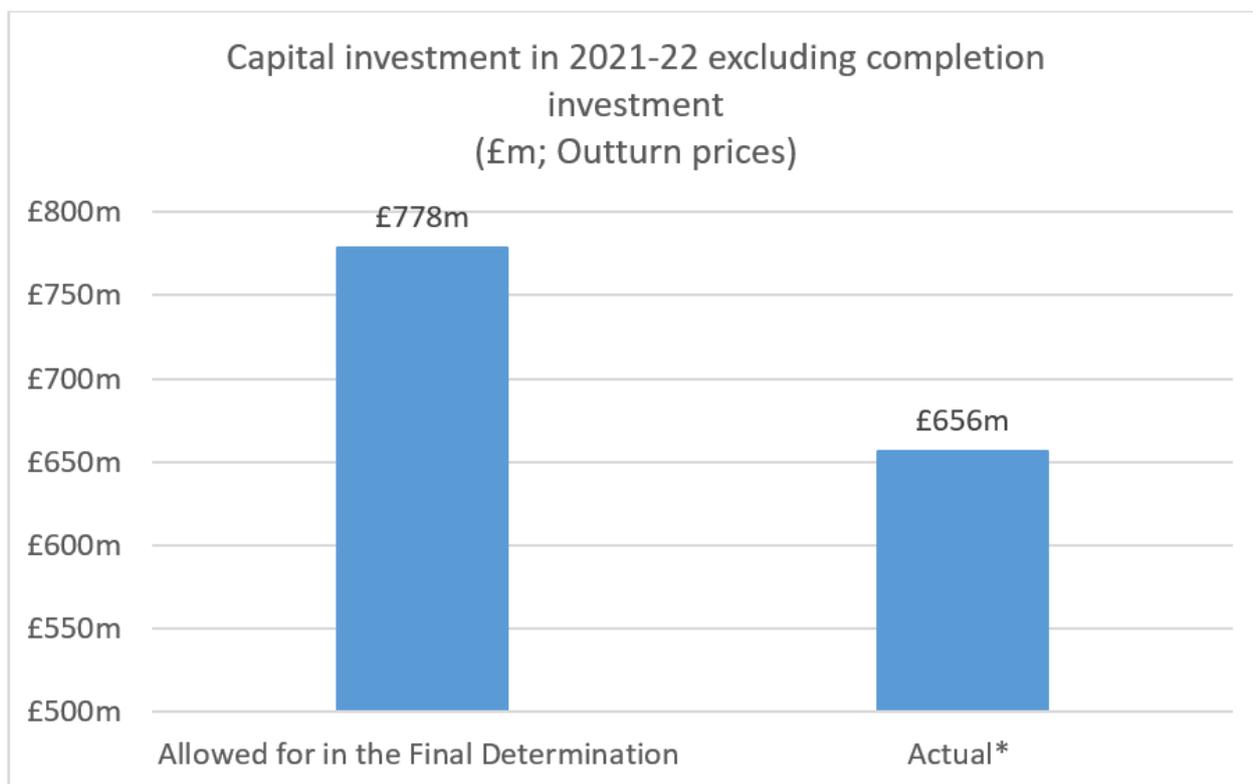
Scottish Water ended the previous regulatory control period (SRC2015-21) with funded investment that had still to be delivered. Having investment outstanding at the end of the regulatory control period is not unusual given the size of Scottish Water’s investment programme. Scottish Water also reports that the response to the Covid-19 pandemic in 2019-20 and 2020-21 had an impact on the number of projects carried forward into the regulatory control period 2021-27 (e.g. due to the closure of sites for three months and measures required to make its sites ‘Covid secure’).⁵ SRC2015-21 had funded 86 projects with a forecast cost of completion of £291m in outturn prices. Customers had paid for the associated benefits, but Scottish Water had not delivered these projects by the start of the current regulatory control period.

Figure 3 shows that Scottish Water’s reported investment in 2021-22 was around £120m lower than the level allowed for in the Final Determination on a comparable basis.⁶

⁵ 86 projects remain outstanding as of 31 March 2021. For context, this compares to 37 projects that were still to be delivered at the end of the regulatory control period 2010-15 and were carried forward into the regulatory control period 2015-21 as reported on page 35 of ‘Scottish Water Delivery Plan 2015 to 2021’.

⁶ Allowed for investment in the Final Determination of £778m in 2021-22 is after adjusting the assumed financial year average cost inflation of 2% in 2021-22 for the outturn cost inflation of 4%. This has the effect of increasing the Tier 1 expenditure in cash terms and therefore reducing the cash available for investment. It also assumes that the £36m of additional borrowing over the period arising from the repayment of the AES bank debt (as explained above) is spread equally over each year of the 2021-27 regulatory control period. This would increase the assumed borrowing in the Final

Figure 3: Capital investment in 2021-22



This difference indicates that there does appear to be some slippage in the delivery of Scottish Water’s investment programme.

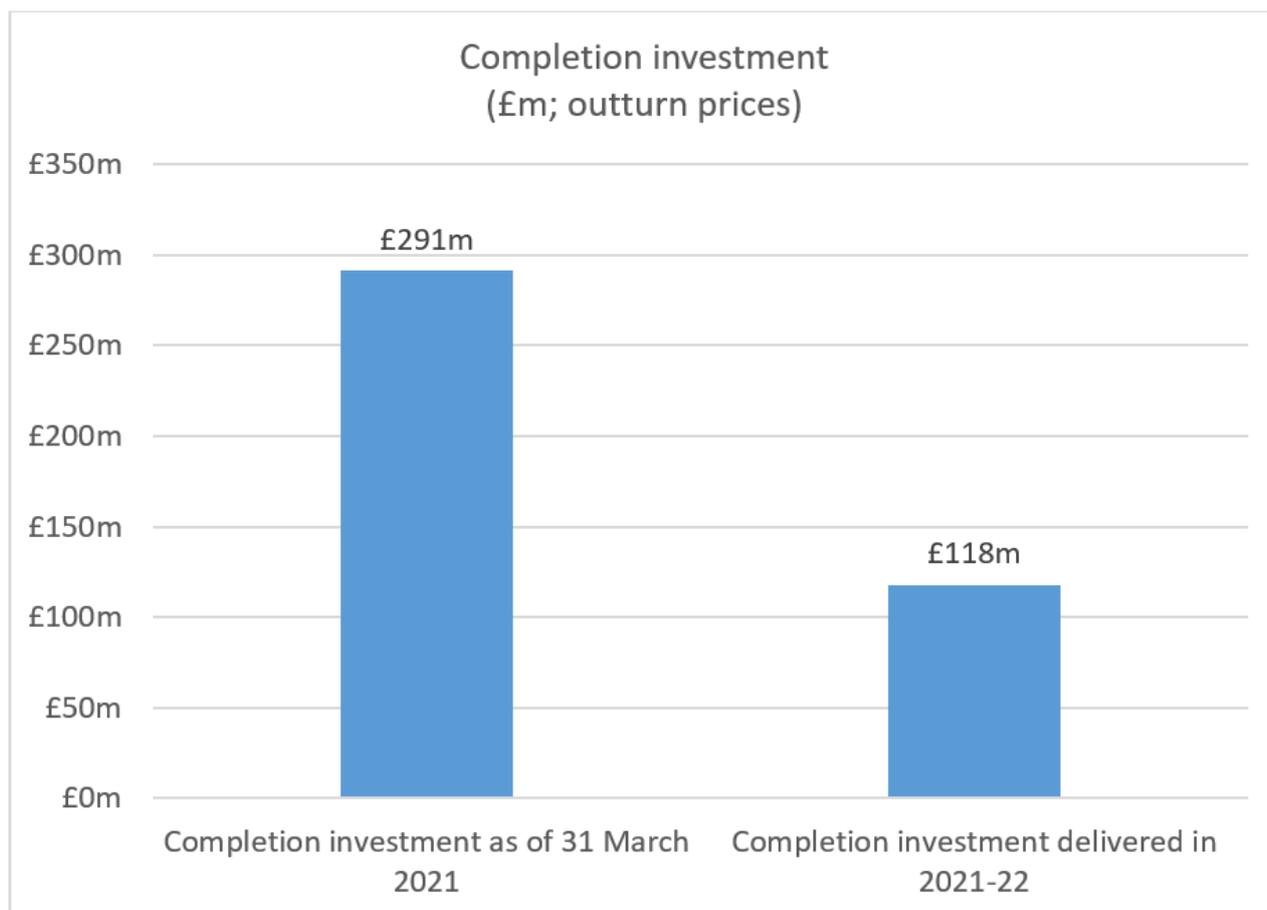
As to the investment still to be delivered from the previous regulatory control period, WICS’ Final Determination required Scottish Water to deliver the completion investment in the first year of the regulatory control period. At the time of the Final Determination, Scottish Water was forecasting that completion investment would be in a range of £120m to £200m, much lower than the actual outturn completion investment of £291m. This further delay in the investment programme in the final year of the 2015-21 regulatory control period increased the challenge expected of Scottish Water. It demonstrates the importance of accurate and evidenced reporting of performance by Scottish Water.

Figure 4 shows the total completion investment as of 31 March 2021 and the level of completion investment delivered in the first year of the regulatory control period.

Determination to £185m in 2021-22. This is in line with Scottish Water’s assumption in the response to the information request as set out in Scottish Water (2022), ‘Item 4 Financial Scenarios – Commentary on Assumptions’, August, p.2.

*Scottish Water reported investment of £799m in its annual report and accounts (p. 5). £656m reconciles with the £799m by adding completion investment of £118 million and reasonable cost contributions of £25m.

Figure 4: Completion investment in 2021-22



WICS concludes that Scottish Water’s investment is lower than anticipated in 2021-22. This shortfall in the delivery of investment is a key contributor to the current elevated cash balance. The cash balance assumed in the Final Determination was £153m whilst Scottish Water’s reported cash balance for the core business was £516m.⁷

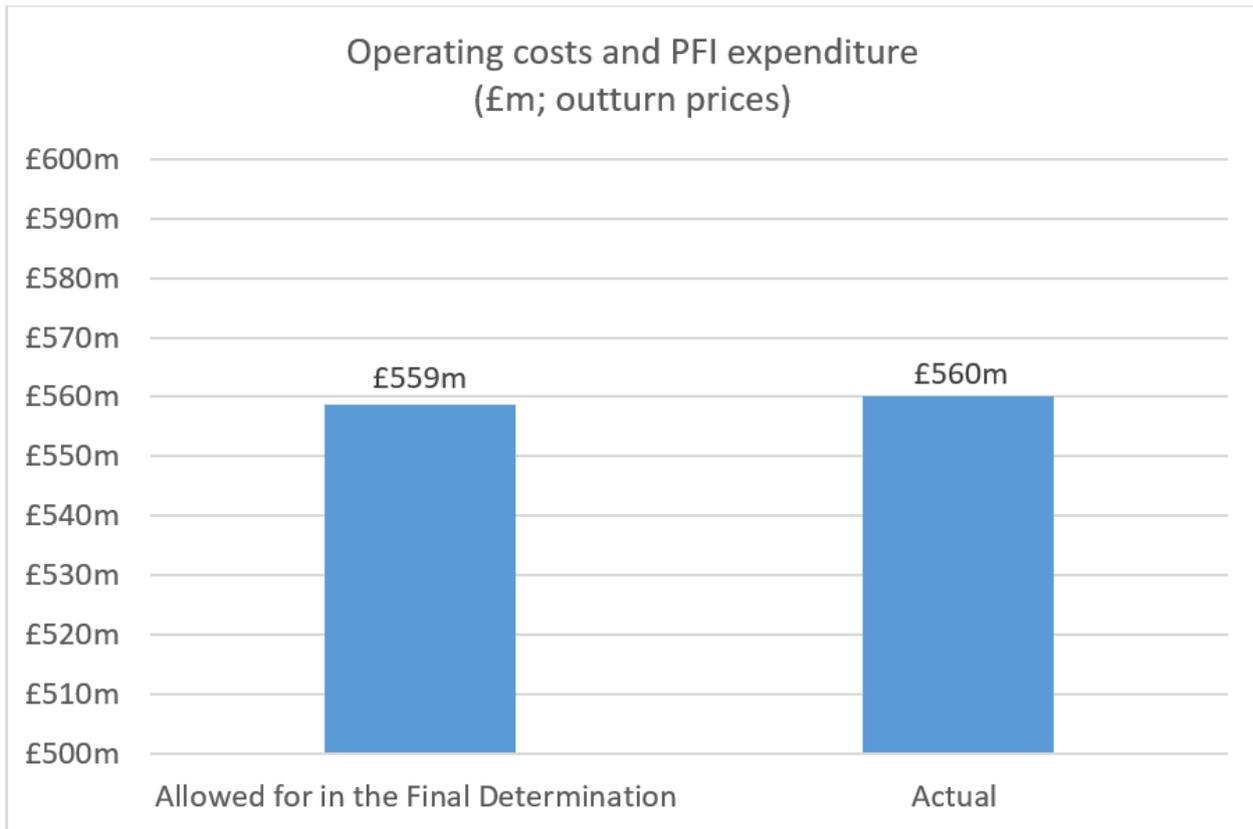
Operating and Private Finance Initiative expenditure

Figure 5 shows that operating and PFI expenditure was in line with the level allowed for in the Final Determination.⁸

⁷ Once restating the Final Determination financial model for the closing financials in 2020-21 and the completion investment of £291m, the closing cash balance in the restated Final Determination model (consistent with Figure 2) would be £123m in 2021-22.

⁸ As explained above, the allowed for operating expenditure in the Final Determination is restated to reflect that Scottish Water redefined operating expenditure to reflect improvements to its systems of cost capture.

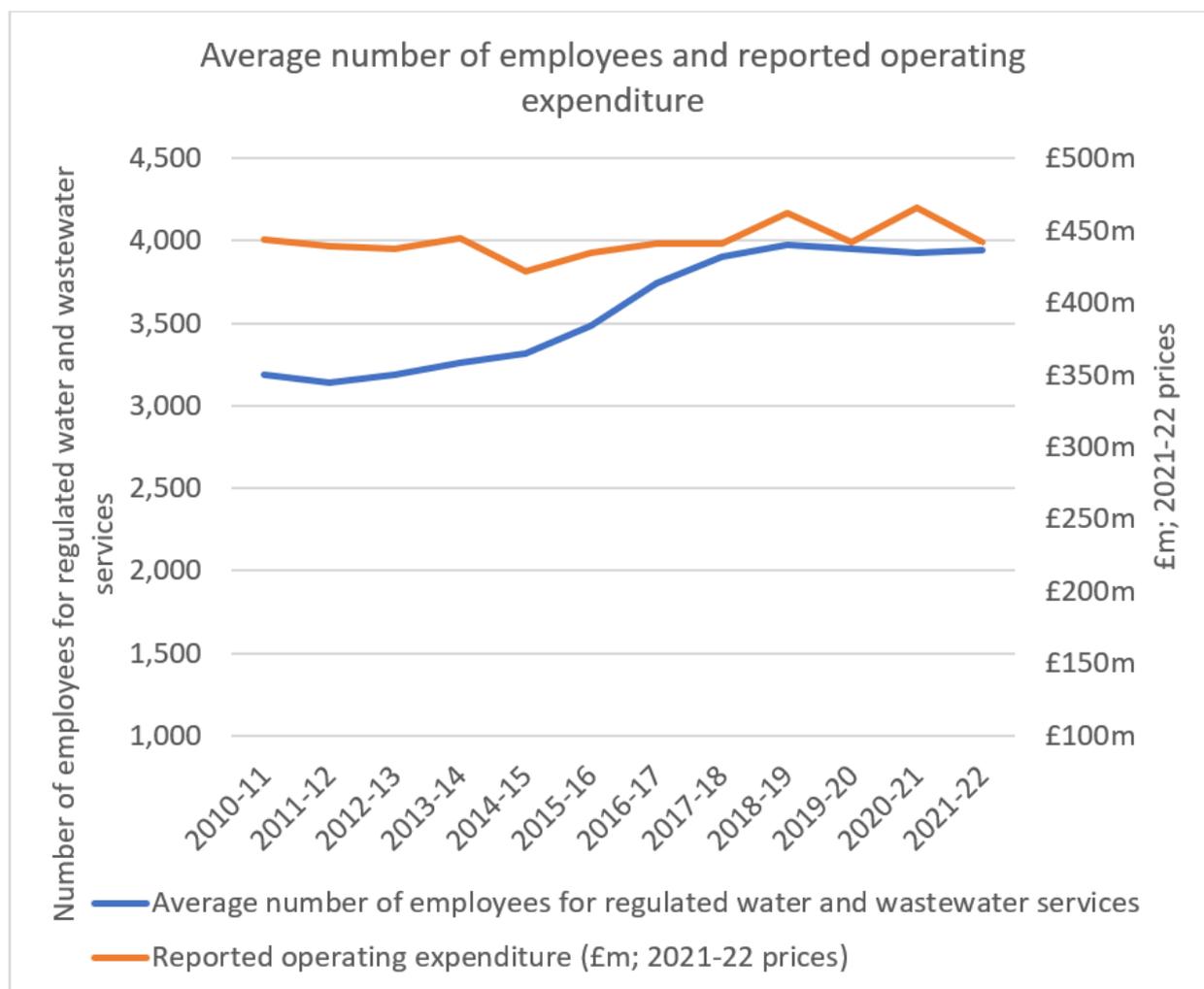
Figure 5: Operating and PFI expenditure in 2021-22



WICS has however raised questions on changes to capitalisation of expenditure over time.⁹ Figure 6 compares reported operating expenditure and the number of employees for the regulated activities.

⁹ These questions are set out in the WICS letter to Scottish Water. WICS (2022), 'reporting quality and completeness', dated 13 December 2022. The letter is published alongside this report.

Figure 6: Operating and PFI expenditure in 2021-22



The comparison shows that operating expenditure has remained broadly flat in real terms since 2010-11;¹⁰ however, the number of employees for the regulated activities has increased by around 25% over the same period.¹¹ Scottish Water explains that the increase in the number of employees is due to moving from an outsourced model of capital delivery (i.e. through Scottish Water Solutions 2), to bringing capital delivery back in house over the period. WICS’ planned work on redefining the regulatory accounting rules should ensure that any changes in capitalisation policies are clear and that the underlying nature of performance can be understood.

Other costs

Scottish Water had lower interest costs than assumed despite having higher net new borrowing in the year compared to the level assumed in the Final Determination (new debt of £235m versus

¹⁰ For consistency with previous years, the reported operating expenditure includes the £50m of repair and refurbishment investment. To allow for comparison to operating expenditure in previous years, this continues to be reported in the regulatory accounts (Table M1, Line 1.24).

¹¹ As reported by Scottish Water in Annual Reports and Accounts 2010-11 to 2021-22.

£180m).¹² This difference in interest costs is due to Scottish Water refinancing its legacy debt that matured in the year at much lower interest rates.

Scottish Water also paid tax of £14.6m in the year. Scottish Water has explained that it expects taxation to increase over time if the transition to increased levels of investment is funded through retained profits. WICS expects Scottish Water to complete further analysis to understand the potential materiality of taxation in the future as part of developing the evidence base for the Strategic Review of Charges 2027-33. It may be that Scottish Water should seek to expense more of its capital expenditure planning and administration costs.

The delivery of key outcomes for customers and the environment in 2021-22

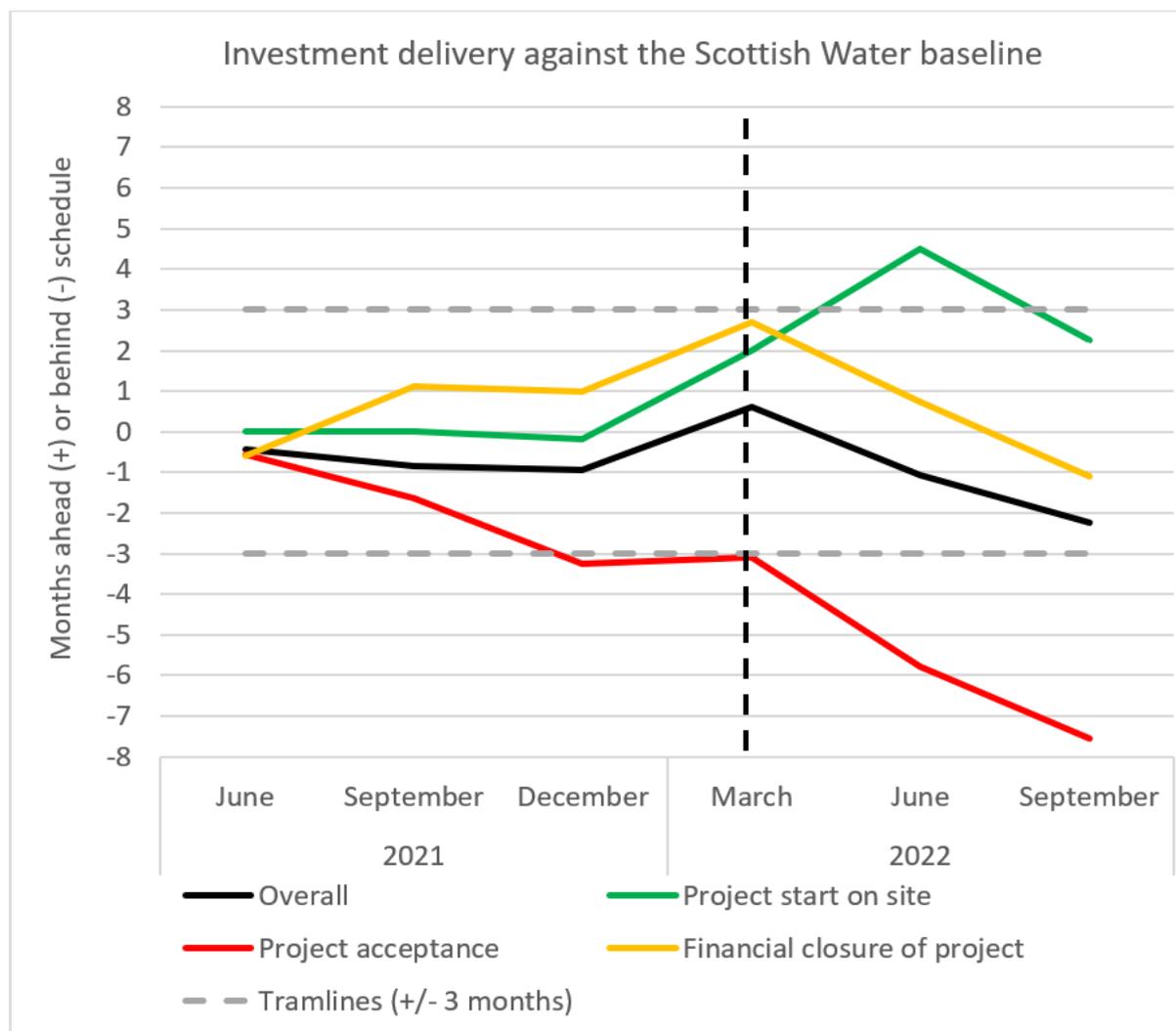
For the regulatory control period 2021-27, Scottish Water developed new measures, which seek to explain progress in delivering the investment programme and levels of service, water quality and environmental performance.

Scottish Water now tracks progress on investment delivery through its Indicator of Progress of Delivery. Scottish Water developed this measure to replace the Overall Measure of Delivery (OMD), which it reported from 2010-11 to 2020-21. As of March 2022, Scottish Water reported that it was on track. Overall performance across all delivery milestones was within the tolerance band of being ahead or behind schedule by three months.

While Scottish Water reports that it is on track overall, WICS and other industry stakeholders have identified that delays appear to be happening once projects are 'on site' and construction has commenced. Examining individual delivery milestones on projects as of March 2022, Scottish Water appears to be around three months behind schedule on completing projects where work has begun on site (as shown by the red line). Six months later, Scottish Water appears to be some seven months behind. This is set out in Figure 7 below.

¹² As explained above, restating the Final Determination to reflect the adjustment for the repayment of AES Ltd bank debt would result in assumed borrowing of £185m.

Figure 7: Investment delivery performance



Similarly, as of March 2022, there was a shortfall in the completion of the 86 projects remaining from the 2015-21 regulatory control period relative to Scottish Water’s own target. Table 1 shows that Scottish Water had delivered 47 of the 68 projects that it had expected to have complete by Quarter 4 of 2021-22 – a shortfall of 21 projects.

Table 1: Progress on completion investment

Number of projects			
Stage	Forecast at March 2021	Actual at Q4 2021-22	Variance
Pre Start on Site	4	6	2
In Construction	14	33	19
Construction Complete	68	47	-21
Total	86	86	0

WICS and other industry stakeholders will continue to monitor Scottish Water’s performance on investment delivery closely, to ensure that customers receive the benefits of the investment they have paid for in a timely manner. Recent experience suggests that more granular reporting of progress in the delivery of the capital expenditure programme will be required in future.

Turning to benefits delivered from the investment programme, Scottish Water redefined the Overall Performance Assessment (OPA) into what it now calls the “New OPA”.¹³ This redefinition involved removing individual measures from the OPA basket of measures that it considers are captured elsewhere (e.g. customer service through the Customer Experience Measures) and changing the weights so that the New OPA is now a score out of 450 points (compared to 418 points available for the OPA in place between 2010-11 and 2020-21).

In 2021-22, Scottish Water reported a score of 398 (88% of total score available) against a target range of 395 – 410 points in 2021-22.¹⁴

WICS would prefer that Scottish Water monitor its performance on a consistent basis. Changes to reporting can make understanding the actual underlying performance much more difficult. WICS intends to continue to collect the information required such that performance can be measured consistently.

Scottish Water suggested its performance on the previous version of the OPA was 394 points for 2021-22.

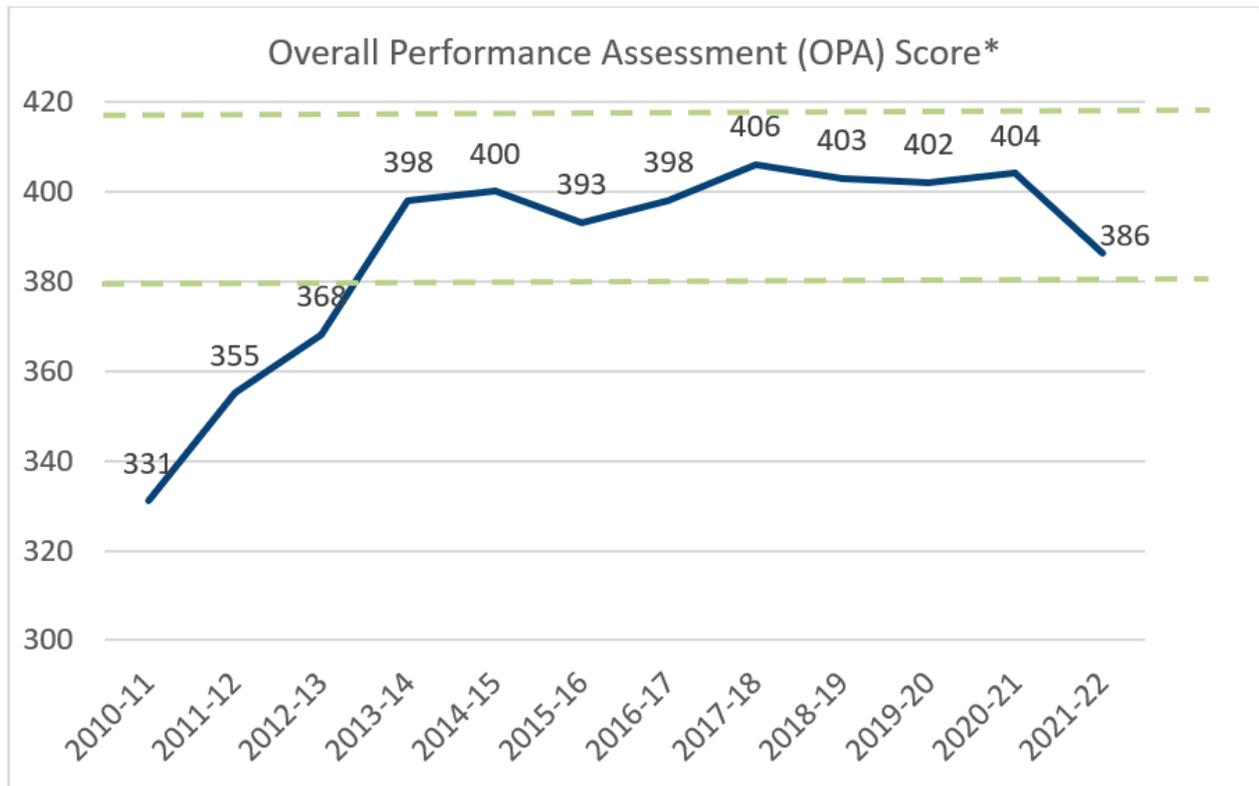
WICS’ review identified two factors that reduced the reported score to 386 points for 2021-22.¹⁵ This score is much lower than in recent years. Figure 8 shows performance over time, based on the OPA introduced in 2010-11.

¹³ Scottish Water changed the name of the measure to the “Outcome Performance Assessment”. The differences to the OPA in place over 2015-21 relate to the removal of Security of Supply (absolute performance and performance against target), Sewer Flooding At Risk, Customer Contact (Written Complaints, Lines Busy, Abandoned Calls, Customer Survey), and Assessed Customer Service measures. There were also changes to the methodology for aggregating the OPA score compared to that in place over 2015-21.

¹⁴ Page 144 of the Scottish Water Annual Report and Accounts for 2020-21 provides a target range for 2021-22. An annual forecast for the 2021-27 regulatory control period is provided in Item 2 Data Return, Table 1, Line 1.6 of the SR21 Information Request received on 31 August 2022.

¹⁵ There was a further adjustment that could have been made based on the Security of Supply Index (SOSI) measure relating to performance against target. While Scottish Water has not set a formal target, if WICS were to use the planned level of service as a proxy for the target, this would have reduced the OPA score to 380 points. However, to be conservative, WICS has not made this adjustment and has instead used Scottish Water’s score for this measure from 2020-21.

Figure 8: Performance on the OPA over 2010-11 to 2021-22

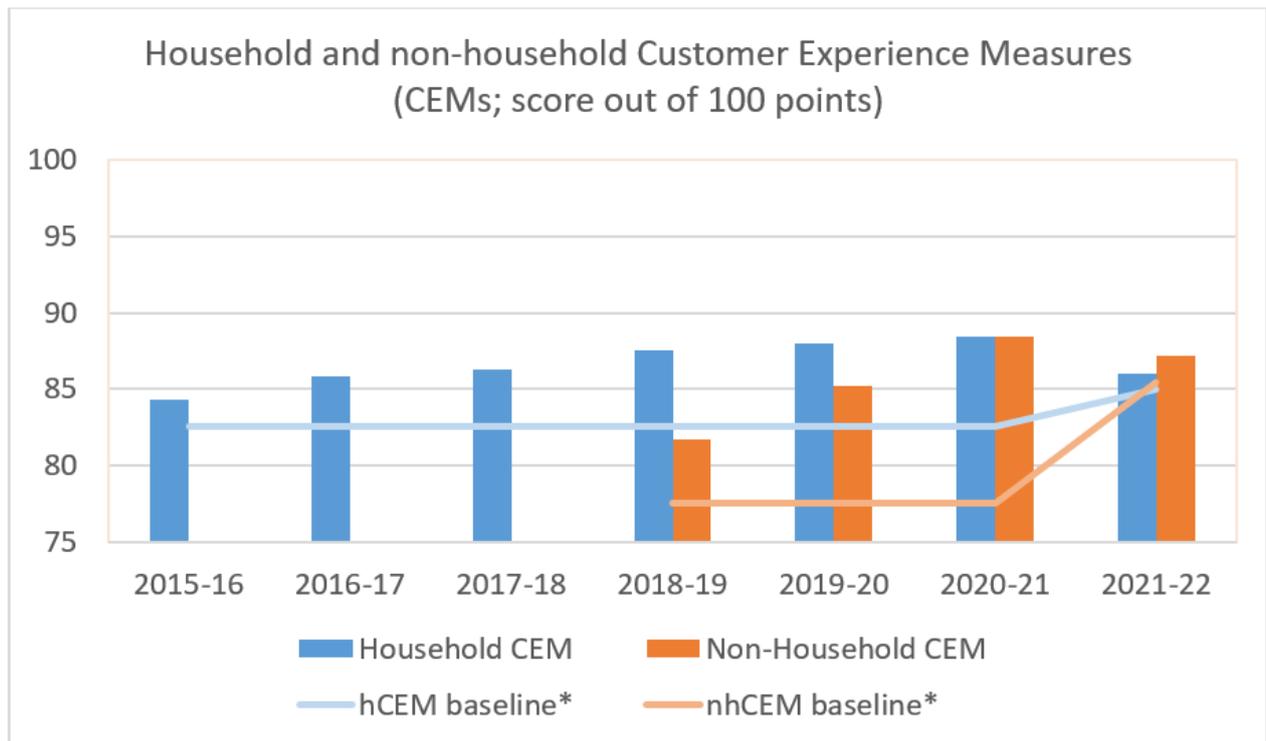


Scottish Water did manage to hold its performance above the 380 threshold that represents the historical lower bound for better performing companies (as indicated by the dashed green lines).

WICS can report that Scottish Water has broadly maintained its performance on the household and non-household Customer Experience Measures. The scores for these measures are shown against the annual targets in the Figure 9.¹⁶

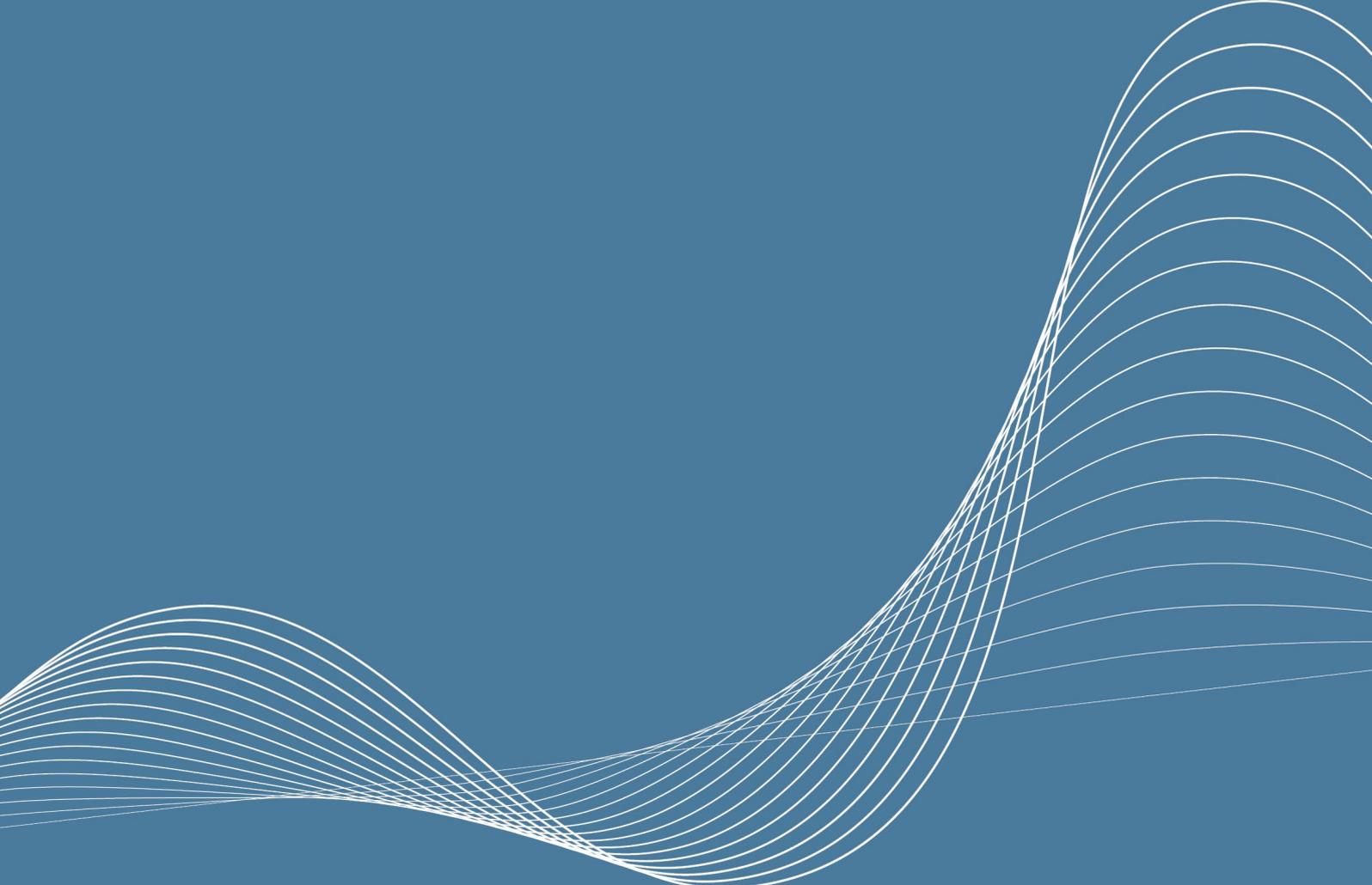
¹⁶ The annual target for household CEM (hCEM) and non-household CEM (nhCEM) is the low end of the target range as reported in B5.31 and B6.39 of the Annual Return and also on page 144 of the Scottish Water Annual Report and Accounts for 2020-21.

Figure 9: Performance on the Customer Experience Measures



Conclusion

WICS' review of performance across the levels of service measures allows it to conclude that Scottish Water has broadly maintained its performance during 2020-21 and 2021-22.



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