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Your Ref:
Reporting quality and completeness

Dear Douglas

Reporting quality and completeness

The WICS Final Determination for the Strategic Review of Charges 2021-27 (SRC21-27) was intended as a first step in ensuring that Scotland would benefit from a sustainably funded water industry, future-proofed and able to be a leader in how Scotland adapts to Climate Change.

In SRC 21-27, WICS recognised that levels of investment would have to increase significantly over the next two decades if the industry were to maintain levels of service in the face of a changing climate. WICS also set out its expectation that Scottish Water should seek both to improve the reporting that it had always provided to its economic regulator and to go further still: Scottish Water should pro-actively tell its economic regulator all that it could ever need to know. Specifically, WICS expected Scottish Water to provide a clear picture of the future investment that could be required and an assessment of the likelihood and timing of this investment. WICS set this out in the Investment Prioritisation and Planning Framework.

WICS saw this as a definitive move away from the previous practice of technical expressions, which Scottish Water 'planned, prepared and delivered' a fixed list of prioritised projects. In WICS' view, such an approach was necessary to allow Scottish Water effectively and efficiently to address the triple, and in many ways conflicting, investment challenges of Climate Change, asset replacement and further improvement in levels of service and regulatory compliance.

Since the Final Determination, WICS has sought to support Scottish Water as it adapts to the new regulatory framework. Unfortunately, it has now had to conclude that Scottish Water is falling short of the expectations set out during the Strategic Review of Charges process.

There are three areas that now particularly concern WICS:

- Scottish Water's reporting of performance has gone backwards in terms of its completeness, accuracy and governance;
- Scottish Water has not provided the expected visibility on future investment needs required by the Investment Prioritisation and Planning Framework; and
- Scottish Water has made limited progress in taking forward the high-level asset replacement work.

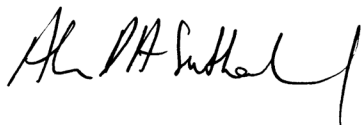
WICS intends to comment further on the regression in reporting standards in its Performance Report for 2021-22. WICS will also make some changes to its required regulatory reporting. In addition to requiring a very significant improvement in the quality of reporting included in the annual return, WICS will also define further its expectations around how Scottish Water reports the revenue and costs of the core business and its reporting of potential future investment needs.

Attached as an appendix to this letter is a fuller explanation of WICS' views. WICS has previously provided an extensive list of its queries on information provided both in the Annual Return and the Information Request from March 2022.

In the meantime, WICS now expects Scottish Water to set out how it plans to gain its regulators trust in how it is applying regulatory accounting rules, pricing transactions between its core and non-core operations, and how it plans to improve its regulatory reporting. Such a plan for improving regulatory reporting should address the scope, completeness, accuracy and should evidence the scrutiny applied by senior management to the information provided to WICS. WICS expects to receive a draft of such a plan by the end of January 2023 such that it could be agreed before the start of the next annual information cycle.

We will be in contact to discuss the expectations set out in this letter and its Appendix in further detail.

Yours sincerely,



Alan D A Sutherland
Chief Executive

APPENDIX ONE

Introduction

The WICS Final Determination for the Strategic Review of Charges 2021-27 (SRC21-27) was intended as a first step in ensuring that Scotland would benefit from a sustainably funded water industry, future-proofed and able to be a leader in how Scotland adapts to Climate Change. WICS identified, in its work with industry stakeholders, that optimising the replacement and refurbishment of assets would likely be a key element in successfully adapting to Climate Change and, importantly, in keeping customers' bills, over the medium to longer term lower than would otherwise be the case. In using the term 'optimising' WICS had in mind that Scottish Water should consider its asset replacement needs in a manner that ensures both current and future needs of customers and communities are met at the right time and with appropriate levels of risk.

The Determination recognised that levels of investment would have to increase significantly over the next two decades if the industry were to maintain levels of service in the face of a changing climate. It explained that charges would have to increase in real terms and that Scottish Water would have to make further considerable efficiencies in both its operating and capital expenditure.

Background

Recognising the long-term nature of the challenges faced, SRC21-27 involved moving to a regulatory approach based on properly candid, evidenced and open conversations about the long-term challenges and how best to tackle them. A fundamental pillar of this Ethical Based Regulation (EBR) approach is that Scottish Water maintains the trust and confidence of stakeholders. WICS has been clear in its expectations: candour plus analysis equals trust.

WICS also considered that Scottish Water should take ownership of its performance reporting if it was to maintain the confidence of stakeholders. This would require Scottish Water to report regularly and comprehensively on performance. In particular, the draft determination explained:¹

“The context and explanation of information should be exemplary, allowing regulators to see consistent, evidenced trends of improved performance. A shortfall in behaviours would, as a direct consequence of adopting this approach, also become increasingly obvious.

Scottish Water should take the difficult steps required to take full ownership of everything that it does and to build and maintain trust in all that it does. As such, it should develop a transparent internal assurance process, which shares its conclusions (initially ‘warts and all’) with all who are interested. The way it is perceived to behave will be a clear indicator of the likely level of trust and confidence that stakeholders will have.”

In accepting the WICS’ Determination of Charges, Scottish Water agreed to take full ownership of the challenges facing the industry and the prioritisation of investment to meet these challenges and accepted the responsibility that came with the offered flexibility. Doing so required Scottish Water to take its lead from customers and communities in making these decisions and to be committed to seek out opportunities to improve and engage in regular and frank discussions of performance on an ongoing basis.

WICS was content to move away from a fixed ‘Technical Expression’ only on the basis that Scottish Water would provide visibility of potential future investment requirements – what WICS has termed the ‘Universe of potential needs and aspirations’ – maintaining this information as a ‘living document’. An appropriate list would set out the implications of the potential choices available. WICS identified the importance of having such information in place in initial discussions with stakeholders on investment planning and prioritisation back in early 2018, with this expectation set out on several occasions starting with the 2018 Decision Paper 3.

WICS decided against establishing interim milestones or ‘gateways’ to judge progress. This reflected WICS’ aspiration that Scottish Water would take ownership of its strategy and the transformation that would be required. In place of milestones, WICS highlighted that Scottish Water should demonstrate progress in its transformation and reporting in a candid and analytically robust way.

¹ WICS (2020), ‘Strategic Review of Charges 2021-27: Draft Determination’, October, p.44.

The Final Determination reiterated the expectations set out in Decision Papers and the Draft Determination. It set out that Scottish Water should:²

- take full ownership of enduring relationships with the customers and communities it serves;
- promote an open discussion of its purpose, aspirations and values;
- set out clearly – and in a way that is accessible to all – its current performance and plans for improvement;
- engage in regular and frank discussion of performance, recognising that performance expectations will always change and become more demanding;
- adopt a collaborative, timely and pro-active approach to meeting the needs and aspirations of its regulators, aiming to address their concerns even before they have had to ask; and
- embrace these challenges as an opportunity – and be seen to do so in a positive and constructive way.

WICS explained that it would assess Scottish Water's progress on transformation (the move towards systems, processes and interactions consistent with an EBR approach) ahead of publishing the methodology for the next Strategic Review of Charges (SRC27-33). Its assessment of Scottish Water's progress would determine the regulatory approach for SRC27-33.

This Appendix continues with an assessment of progress to date.

Progress since the Final Determination

Following Scottish Water's submission of a revised Charges Scheme for 2022-23 and reflecting developments since the Final Determination, WICS sought clarity on how Scottish Water planned to manage its costs and revenues and deliver the required investment over the 2021-27 regulatory control period in a manner consistent with the Final Determination of Charges.³ To underpin this explanation and provide WICS with a full understanding of Scottish Water's plans, WICS sent a letter to Scottish Water on 10 March 2022 asking it to complete an information

² WICS (2020), 'Final Determination: Strategic Review of Charges 2021-27', December, p.16.

³ WICS Letter reference '22-23 Charges Scheme Approval', sent on 3rd February 2022.

request.⁴ Following meetings with Scottish Water and further letters,⁵ Scottish Water agreed to provide WICS with a response to the information request by 31st August 2022.⁶

Both the development of the strategy and the response to the information request were intended to provide visibility of future investment needs to support investment planning and prioritisation. Progress was therefore expected in both areas by the Scottish Water September 2022 Board meeting.⁷

Current Situation

There are three areas where WICS now considers Scottish Water to be falling short of the expectations that were set out in the Strategic Review of Charges. These are:

- The reporting of performance;
- Scottish Water providing visibility on future investment needs to support investment planning and prioritisation; and
- Taking forward the high-level asset replacement work.

The reporting of performance

Candid reporting of the company's performance and future prospects supported by robust analysis was seen as critical to giving Scottish Water the necessary time and space to transform. WICS considered that it could allow Scottish Water this time and space as it could rely on its annual return process as a minimum.

However, in the last three years after the approach to the current regulatory control period was finalised, the quality of regulatory reporting has gone backwards in terms of its completeness, accuracy and governance. WICS has had to take steps to ensure that it has access to information of sufficient quality. These included:

- requiring resubmission of commentaries and undertaking an extensive query process for the annual return 2019-20;

⁴ WICS letter reference 'Information Request', sent on 1st March 2022.

⁵ WICS letter reference 'Information Request – Timescales for completion', sent on 25 April 2022; and WICS letter reference 'Information Request – Timescales for completion', sent on 10 May 2022.

⁶ Scottish Water letter dated 31 May 2022.

⁷ Slide titled 'We would assess progress in three areas by the September Board meeting', shared with Scottish Water on 7 April 2022.

- undertaking an extensive query process and requiring resubmission of the investment tables for the annual return 2020-21, with the final investment tables submitted on 28 July 2022;
- undertaking joint working with Scottish Water from October 2021 to May 2022 to review and update the annual return 2021-22; and
- requiring resubmission of the full annual return 2021-22.

WICS has also now identified further areas where greater clarity is required from Scottish Water. These include:

- capitalisation policies and application of regulatory accounting rules;
- the definition of 'core' and 'non-core' activities and the cash flows between these activities which may not be consistent with the assumptions made during the Strategic Review of Charges; and
- the definition of operating costs, repair, refurbishment and asset replacement costs which are not consistent with the assumptions made during the Strategic Review of Charges.⁸

Given that Scottish Water has fallen short of the expectations that underpinned the current regulatory control period, WICS is now setting out its requirements.

Visibility of future investment needs

Scottish Water's response to the Information Request should have been an important step in providing visibility of future investment needs. WICS' review of the information provided has identified a number of material gaps and inconsistencies. In the absence of the required 'universe of potential needs', it is difficult to see how substantial progress on Scottish Water's strategy can be made.

Taking forward the high-level asset replacement work

WICS welcomed the work that Scottish Water embarked on with Professor Dr Bryan Adey to develop the capacity, capability and process to better manage its infrastructure on behalf of customers.

Professor Adey identified the importance of having clear asset class policies in place, strategies for how to intervene based on these policies and integrating these strategies into investment planning and system planning. WICS recognised that the approach of Professor Adey should help Scottish Water highlight to stakeholders in a consistent and transparent way:

⁸ This includes, for example, the movement of allowed for expenditure from operating expenditure to repair and refurbishment expenditure (Tier 1a), which Scottish Water explains is due to improved cost capture.

- what choices are being made;
- what the implications of the choices being made are (for current and future customers); and
- how they are being made.

The current Management Approaches that were agreed with the Scottish Water Board during 2019 and 2020 appear to represent a reasonable first step in this journey.

Both Professor Dr Adey and WICS have identified potential improvements that can and should be made. As explained in feedback provided to date, the basis of many of these approaches is inconsistent. Some are based on asset condition, some on current performance and some on future desired outcomes. This inevitably results in overlap and a consequent loss of clarity as to how and why a particular decision is being taken. This needs to be addressed.

WICS also expects Scottish Water to demonstrate a commitment to the high-level asset replacement work and provide clarity on how it would consider interactions between maintenance policies, risk and the high-level asset replacement requirements. Recent progress has been limited.

Actions to be taken

Given assessed progress to date, WICS will increase the level of prescription in its required regulatory reporting. WICS has identified two areas that it proposes to add to its annual information requirement. These are:

- The regulatory ringfence and the reporting of Scottish Water's revenue and costs; and
- The provision of the universe of investment needs.

WICS will set out its expectations for the next regulatory control period in greater detail in its methodology for the next Strategic Review of Charges. Some initial considerations are outlined below.

The regulatory ringfence and the reporting of revenues and costs

WICS notes that, in revenue terms, Scottish Water's non-core activities have grown from £230m in 2017/18 to £450m in 2021/22 (outturn prices, excluding inter-company transactions). The growth appears to be driven by:

- Business Stream's acquisitions of the non-household retail activities of Southern and Yorkshire Water and organic growth in England.
- Growth in Scottish Water's renewable energy portfolio, which is held by its subsidiary, Scottish Water Horizons.
- Scottish Water's recent acquisition of Private Finance Initiative Schemes and the creation of new subsidiaries, Aberdeen Environmental Services Limited and Scottish Water Services (Grampian) Limited.

The growth in these non-core activities has added complexity to WICS' scrutiny of the core business of Scottish Water. There also appear to be a significant increase in the frequency and magnitude of the inter-company transactions between Scottish Water's core and non-core activities. Some of the examples of particular relevance to WICS include:

- the financing flows between Scottish Water, Scottish Water Horizons and Scottish Water Business Stream and the availability of borrowing facilities to Business Stream;
- financing flows between Scottish Water's core business and Scottish Water Horizons for renewable energy; and
- transactions between the core business of Scottish Water and its PFI subsidiaries and the lack of visibility of expenditure in the PFI subsidiaries. It is also important to ensure that the benefits of debt classed as public expenditure accrue only to the core business of Scottish Water.

WICS considers that the cash flows between the 'core' and 'non-core' activities of Scottish Water may not be consistent with the information modelled at the last Strategic Review of Charges.

WICS also expects further clarity on:

- capitalisation policies and application of regulatory accounting rules; and
- the definition of operating costs, repair, refurbishment and asset replacement costs which have been restated since the Strategic Review of Charges.⁹

It is important that WICS has confidence in the reasoning that underpins the reporting of costs. And these costs should both be accurate and relate solely to the operation of the core business of Scottish Water.

⁹ This relates to the movement of operating expenditure to capital expenditure (i.e. the £300m of costs allocated to Tier 1a as identified in Appendix A of the document 'Scottish Water SR21 Investment Planning Scenarios and Recovery Options), which Scottish Water explains is due to improved cost capture.

Asset replacement and the universe of investment needs

As previously explained, there needs to be clarity about what customers and communities can expect for the charges that they pay and other potential priorities that will not be affordable.¹⁰ It is perhaps worth reiterating that only through having full visibility of future investment requirements can stakeholders have confidence that pursued projects are genuinely the highest priority and would allow Scottish Water to realise its strategy and make appropriate progress towards achieving the industry vision. WICS will make the provision of the 'universe of potential needs' a core element of its information framework.

WICS also considers that, for the next stage of the asset replacement work, it will be important to understand the extent to which 'optimising' a replacement will address future challenges for the industry. There is currently insufficient understanding as to what is termed 'replacement' and 'enhancement' or 'growth'. Enhancement investment should only be recognised when it is genuinely incremental to what is achieved through a fully funded programme of optimised replacement. Such clarity will be essential to inter-generational equity.

The challenge of adapting to Climate Change increases the urgency of understanding how best to optimise the replacement of sewer and drainage systems.

¹⁰ WICS (2018), '2018 Decision Paper 3: Investment planning and prioritisation', p.4 which refers to Scottish Water developing "an extensive list of potential requirements and aspirations"; and WICS (2020), 'Strategic Review of Charges 2021-27: Draft Determination' which explained that the "the introduction of the Investment Planning and Prioritisation framework requires Scottish Water to improve its understanding of all of the interventions that may be required".