STRATEGIC REVIEW OF CHARGES 2027-2033: DRAFT METHODOLOGY

14 August 2024

WICS Economic regulation for Scotland's water

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INTRODUCTION

Water is a precious resource, essential for both life and our economy. As a society, we rely on Scottish Water to deliver clean, high-quality drinking water at the turn of a tap, responsibly collect and treat wastewater and surface water, and return it to the environment without detriment – all while ensuring these services remain affordable.

The people of Scotland have benefitted considerably from a model where Scottish Water is publicly owned, commercially run and subject to rigorous independent economic regulation. As a result, water charges in Scotland remain among the lowest in the UK, while Scottish Water has invested the most per person since 2002.[1] This investment has enabled Scottish Water to make significant improvements in the levels of service it provides.[2] Scottish Water is among the top-ranking companies in Scotland on customer service, as measured by the UK Customer Satisfaction Index (UKCSI)[3], and it outperforms the average UKCSI for the water sector across the UK.[4]

As economic regulator we play a key role in ensuring that Scottish Water delivers for the people of Scotland. One of the ways that we fulfil this role is by setting caps on Scottish Water's charges through a process known as the Strategic Review of Charges. Through this process, we make sure that customers pay no more than is necessary for essential water and wastewater services. We carefully monitor and report on Scottish Water's performance and investment to ensure it is efficient and effective in delivering high-quality services now and for years to come.

Looking ahead, our approach for the Strategic Review of Charges which covers the six-year period 2027-33 (SRC27) will create a framework from which Scottish Water can continue to improve and make progress delivering against key challenges. It will focus on:

- Maintaining high standards of service and reliability
- Improving the evidence and analysis which supports decision-making
- Investing for a sustainable industry at lowest reasonable overall cost
- Placing customers at the heart of decision-making

[1] This is based on comparing Scottish Water to the water and sewerage companies in England and Wales over the same timeframe.

[2] Over the period from 2002-03 to 2022-23, Scottish Water levels of service (as measured by the overall performance assessment metric) has trebled. See Figure 4 in section 2.5 of the methodology document.

[3] Scottish Water ranked 6th out of 22 companies from Scotland on the UK Customer Satisfaction Index (UKCSI) survey score in 2024. The Institute of Customer Service publishes the UKCSI survey score as an objective, independent perspective on the state of customer satisfaction in the UK across 13 sectors.

[4] Scottish Water scored 77.1 points out of 100 on the UKCSI compared to the average for the water sector of 70.7. See Institute of Customer Service (2024), *'UK Customer Satisfaction Index: the state of customer satisfaction in the UK'*, July 2024, p.73; and Scottish Water's annual return for 2024, which will be published on the WICS website in late 2024.

This draft methodology sets out the direction of travel for Scottish Water to make further progress on the journey towards delivering the water sector vision and ensuring the industry is sustainable for generations of customers to come.

As in 2021-27, our approach is underpinned by the principles of Ethical Business Practice and Regulation (EBP&R) which will continue to support open and frank conversations about industry challenges and the best ways to address them.

We look forward to working closely with Scottish Water, SEPA, DWQR, Consumer Scotland and other stakeholders throughout this Strategic Review of Charges.

We value input on our proposals to improve the regulatory framework for SRC27 and we are inviting responses to this consultation by 12pm on 9th October 2024.

This overview sets out the high-level principles and proposals contained within our detailed draft methodology document.

THE STRATEGIC REVIEW OF CHARGES

Every six years, we examine the resources that Scottish Water needs to provide high-quality water and sewerage services both now and into the future, ensuring that as a sector we can adapt and evolve to the challenges and uncertainty of climate change. We do this by determining the level of revenue Scottish Water must collect through charges to deliver the Objectives set for it by Scottish Ministers.

After analysing Scottish Water's costs and efficiency, we set a cap on the charges it can collect from customers over a six-year regulatory control period. This process is known as the Strategic Review of Charges. Our Strategic Review of Charges involves working closely with other organisations in the water industry to ensure that the charge caps we set allow Scottish Water to deliver the environmental, water quality and service objectives set by the Scottish Ministers.

At an early stage of the Strategic Review of Charges we set out how we propose to set charge caps and a detailed timeline in line with the requirements set by Ministers in the Commissioning letter. This document, known as our methodology, sets out our proposed approach for SRC27.

In developing our methodology for SRC27, we consider our regulatory approach and where there are opportunities to strengthen the model. This involves reviewing our approach in previous Strategic Review of Charges and building on the elements that worked well, ensuring that we are looking to the future and helping to deliver maximum benefits for Scotland's water customers.

OUR REGULATORY APPROACH

Our process to determine charges for the regulatory control period covered by the Strategic Review of Charges 2021-27 (SRC21) concluded with the publication of our Final Determination in December 2020. We adopted the principles of EBP&R, which requires candour and transparency in all communications between regulator and regulated company. This approach facilitates open and honest discussions about the long-term challenges the industry faces and how to address them.

Our SRC21 regulatory approach placed more emphasis on working together to tackle industry challenges, such as delivering net zero emissions by 2040 and investing to replace Scottish Water's ageing assets. This review represented an important step in the journey to move away from the short term thinking inherent in traditional regulatory models, towards working together to deliver the best outcomes for Scotland's current and future customers. It provided Scottish Water with a high degree of flexibility in its investment planning, since it was in customers' interests to reduce the regulatory barriers to collaboration and innovation; two key elements to tackling these long-term challenges. It was one of our most collaborative Strategic Review of Charges to date and it paved the way for the first joint water sector vision.

Box 1: Sector vision

The water sector vision

- Scotland's water sector will be admired for excellence, secure a sustainable future and inspire a Hydro Nation.
- Together we will support the health and wellbeing of the nation.
- We will ensure that all of Scotland gets excellent quality drinking water that people can enjoy all of the time. Scotland's wastewater will be collected, treated and recycled in ways that generate value and protect the environment.
- We will enable the economy to prosper.
- We will transform how we work to live within the means of our planet's resources, enhance the natural environment and maximise our positive contribution to Scotland achieving net zero emissions.
- We will involve and inspire Scotland's people to love their water and only use what they need.
- We will promote access to the natural environment and encourage communities to enjoy and protect it.
- We will be agile and collaborate within the sector and with others to be resilient to the challenges which will face us.
- We will keep services affordable by innovating and delivering the greatest possible value from our resources, helping those who need it most.
- We will serve all customers and communities in a way that is fair and equitable to present and future generations.
- We are a vital part of a flourishing Scotland.

The importance of adopting a more flexible regulatory framework was highlighted during the early years of the 2021-27 regulatory control period. At this time, the UK experienced a period of high inflation and the cost of living crisis that arose from the Covid-19 pandemic and geopolitical factors. The regulatory framework enabled Scottish Water to respond by reprofiling charges and investment to ease the financial pressures on individuals and families across Scotland.

Climate change is also placing increasing pressure on our essential services, and it will be important to ensure that the water industry continues to adapt to climate change, while recognising these challenging economic times. It is essential for Scottish Water to evidence the investment it requires and play its part in improving efficiency, to reduce the impact on customer charges. We also need to ensure there is clarity over what Scottish Water will deliver, when and at what cost to ensure that customers receive the benefits they have paid for.

OUR APPROACH FOR SRC27

Recognising these key long-term challenges, the Scottish Government is currently developing policy that will determine the guiding principles for the water industry as it addresses longer-term challenges including climate change adaptation and mitigation. The policy work focuses on equipping the water industry with the necessary tools and legislation to ensure that essential water, wastewater and drainage services can continue to be provided in a changing climate.

Through this policy development work the Scottish Government has consulted on principles that will underpin the water industry's approach to providing water, wastewater and drainage services for decades to come. The Strategic Review of Charges 2027-33 will be an important step on the journey towards responding to these longer-term challenges in line with the policy principles and is reflected in our proposed approach.

The publication of this methodology is an important first step in the Strategic Review process and represents the next phase of the journey towards ensuring the Scottish water industry is equipped to face future challenges.

Our approach will be a natural continuation of the progress towards the longer-term thinking initiated as part of SRC21 and reflect the lessons learned from that process. It will place even greater emphasis on the evidence and analysis that Scottish Water will provide. Our approach will also ensure there is appropriate flexibility and adaptability in the framework.

KEY PRINCIPLES

Taking account of the strengths of the regulatory framework to date, we propose that SRC27 will be based on the following key principles:

Figure 1: The key principles of SRC27

Embedding the principles of ethical business practice and regulation (EBP&R)

Our approach will continue to be underpinned by the principles of EBP&R. We will aim to ensure there is a high level of engagement throughout the Strategic Review of Charges process, consistent with EBP principles and consultation best practice. We will ensure the customer voice is placed at the heart of the decisions taken in SRC27.

A focus on high-quality evidence and analysis

Our proposals for SRC27 place even greater emphasis on evidence-based decision making, including demonstrating how risk is both understood and taken into account. As such, we will focus on the quality of Scottish Water's evidence and analysis underpinning how it plans to meet Scottish Ministers' Objectives in the context of the water sector vision.

We expect Scottish Water to provide a range of options for investment, including innovative and nature-based solutions to support a range of possible charge paths which demonstrate best value for customers.

Ensuring clear accountability

It is important that Scottish Water has full ownership and accountability for its performance during the regulatory control period. This requires defining what Scottish Water is expected to deliver during 2027-33, in the form of financial forecasts and commitments, and then monitoring Scottish Water's progress over this period. If investment priorities change over time, then EBP&R places a greater onus on Scottish Water to explain and document the changes it intends to make through the Scottish Government Investment Group (SGIG).[5]

Building appropriate flexibility

We recognise that Scottish Water needs sufficient flexibility to respond effectively to the challenges it faces, particularly where changes in risk or additional evidence impacts the investment priorities.

CONSULTATION QUESTIONS

- To what extent do you agree with the key principles outlined for SRC27?
- Are there other relevant principles that should be considered? Why?

OUR PROPOSALS

Our approach to SRC27 is rooted in regulatory best practice and will deliver best value for customers while helping to improve the overall sustainability of the water industry.

Our proposals are based on Scottish Ministers expectations, as set out in the Commissioning letter, and the lessons learned from SRC21 and in the first three years of the current regulatory control period.

We have summarised our proposals in this overview based on key themes and outline the benefits we expect our proposals to bring to customers and the overall regulatory framework.

A long-term approach

As set out above, SRC27 will be an important step on the journey towards responding to these longer-term challenges in line with the Scottish Government's policy development work and policy principles.

We aim to ensure that Scotland's water industry is sustainable for the long term, so that future generations can rely on the same services we enjoy today. This means that Scottish Water needs to invest in addressing long-term challenges, such as maintaining and replacing assets, adapting to and mitigating the impacts of climate change, and transitioning to net zero. Considering these broader industry challenges, we will continue to adopt a long-term approach to determining charges for 2027-33.

[5] The Scottish Government Investment Group (SGIG) is the group that ensures that the water industry is developing a sufficient programme of investment to meet the Objectives that Ministers set and that the industry is delivering on these objectives. The Scottish Government chairs the SGIG. The governance process relates to how Scottish Water develops the investment programme through the IG. Scottish Government (2024), '*Water Industry: Scottish Government Investment Group'*.

In light of these challenges and difficult economic circumstances, it is even more critical for Scottish Water to communicate clearly the progress it is making towards achieving its contribution to the water sector vision outcomes and Ministerial Objectives, including the overall benefits that will be delivered to customers.

To support this, we will ask Scottish Water to prepare a business plan in the context of the water sector vision outcomes and that sets out clearly the progress it will make towards delivering these outcomes during 2027-33.

The business plan will be evidence-based and set out:

- price profiles and assumed levels of borrowing;
- the allowed for level of investment;
- a forward-looking plan for investment projects and nature-based solutions;
- the outputs necessary to deliver or contribute to the outcomes in the water sector vision in the near term; and
- levels of service measures and annual commitments for those measures.

Through this business plan, we will hold Scottish Water accountable for its performance throughout the regulatory control period ensuring that benefits to customers are delivered in the most efficient way.

As part of its forward-looking plan for investment, we will require Scottish Water to set out its approach to maintaining the vast network of pipes and treatment works used to provide the water, wastewater and drainage services that we all rely upon in our daily lives. These assets have finite lives and will require replacement as well as ongoing servicing, repair and refurbishment. Given that many of these assets last several decades, we need to consider how the costs of maintaining these assets are shared between current and future customers. SRC21 started a journey towards gaining a better understanding of the future maintenance requirements and transitioning towards a level of charges that reflect the full cost of replacing assets over time.

Our approach in SRC27 will require Scottish Water to continue improving its understanding of long-term asset replacement costs. As part of improving this understanding, we will require an investment baseline which includes clear descriptions of expected measurable outcomes across different asset categories and how these investments will impact the condition and performance of the asset base. We will also require that Scottish Water sets out the medium and long term consequences of not making these investments, recognising that this will impact on levels of service, risk and the costs borne by future customers.

This approach will enable Scottish Water to deliver a sustainable industry where current and future generations of customers continue to receive high-quality services.

CONSULTATION QUESTION

- What further information could Scottish Water provide in its business plan?

Clear ownership

In line with the principles of EBR&P, it is important that Scottish Water has full ownership and accountability for its performance during the regulatory control period – this means it must have full ownership of its business plan and overall delivery of its investment programme.

In line with good regulatory practice, we will require Scottish Water's Board to provide an assurance statement on each of the key areas that will significantly impact the outcome of the Strategic Review of Charges. These areas will include that the business plan:

- commands customers' support;
- is consistent with the long-term sector vision (see Box 1);
- is efficient and contains challenging proposals for efficiency and levels of service performance;
- is deliverable, considering factors such as the capacity of the supply chain in Scotland to deliver the proposed investment programme; and
- maintains an appropriate level of financial strength over the 2027-33 regulatory control period, to ensure that proposals for 2027-33 are not storing up problems for the future.

Additionally, we will work with Scottish Water to create an external assurance framework that will offer additional verification of the data and explanations included in the business plan.

This approach will enable Scottish Water to demonstrate to customers and industry stakeholders how it has ensured the robustness of its information and establish a high degree of confidence in its business plan.

CONSULTATION QUESTION

- Which key elements of Scottish Water's business plan would benefit most from assurance? Why?

Ensuring efficiency

Scottish Water must demonstrate that its proposals for expenditure are efficient and deliver the best possible value for customers' money.

We will require Scottish Water to provide evidence of efficiency in both its operating and capital expenditure. As part of this, we expect Scottish Water adopt different techniques and comparators including making greater use of benchmarking against the performance of the companies in England

and Wales. Specifically, we will ask that Scottish Water uses the statistical models developed by Ofwat (the economic regulator of the England and Wales water industry) and tested by the Competition and Markets Authority in Ofwat's price review in 2019 (PR19) and those that Ofwat has developed for its price review in 2024 (PR24). We consider that this approach places greater ownership on Scottish Water; however, we will also test proposals thoroughly to ensure that Scottish Water continues to challenge itself to improve its efficiency.

In line with the Scottish Government's policy development work, we expect Scottish Water to adopt different ways of working to address the challenges posed by a changing climate. We will encourage Scottish Water to work in partnership with others to find better solutions for customers and the environment. These include nature-based solutions such as catchment management and adopting blue-green infrastructure to deal with excess surface water. Such solutions can deliver broader benefits such as reduced greenhouse gas emissions and enhancing Scotland's natural and social capital.

This approach will ensure that customer charges are no higher than necessary and that customers receive wider benefits from investment.

CONSULTATION QUESTION

- To what extent do you agree with the proposed approach to assessing Scottish Water's efficiency?

Evidence based investment

We expect Scottish Water to translate the Scottish Ministers' Objectives and its contribution to the outcomes of the water sector vision into specific service measures and annual commitments. SRC27 will require Scottish Water to develop an investment programme designed to meet these commitments.

In the Commissioning letter, Scottish Ministers have set out that they expect a suitable governance structure to be developed which identifies, on a rolling basis, the outputs necessary to deliver their Objectives. Consequently, by the time Scottish Water submits its business plan, its investment proposals will be at different stages of development, from pre-optioneering to projects that are underway. Our approach in SRC27 recognises that Scottish Water's investment will be at different stages of maturity and tailors our approach for reviewing the investment accordingly.

For investment at an early stage of development (pre-development stage in the investment planning process), we will test the reasonableness of Scottish Water's assumptions for indicative costings and outputs and conduct high-level benchmarking. For investment that is more developed or underway, we will request standard information for projects in excess of £3m and programmes of work.[6] This information will include forecast costs, outputs, interim milestones and milestones for projects post commitment. We also require Scottish Water to clearly set out the completion investment and the source of funding for this investment, to ensure that customers receive the benefits they have paid for.

We will use this information to evaluate the efficiency of Scottish Water's proposals and set an investment baseline in the Final Determination. We recognise that the scope and cost of some investment projects may change as they progress through the investment planning process. We will use the Final Determination investment baseline as a reference point for reviewing the investment progressing through the revised governance process on a rolling basis.

The flexibility of the investment planning process places the onus on Scottish Water to explain and document any changes to the investment baseline over the regulatory period, in order to allow stakeholders to hold Scottish Water to account for delivery on behalf of customers.

We are proposing two key changes to the investment planning process to meet our regulatory requirements:

- To support our monitoring of Scottish Water's performance, we will ask Scottish Water to produce a delivery plan showing how it proposes to meet the requirements of the Final Determination and an annual delivery plan refresh before each financial year which captures the changes to the investment baseline.
- An additional step in the investment planning process when a project is in development, which would involve us reviewing the efficiency of Scottish Water's proposed investment. We would not propose reviewing all projects; however, we propose to review a sample of projects or specific projects that stakeholders consider merit a review. We consider that such a review is consistent with our duties to set charge caps consistent with the lowest reasonable overall cost of Scottish Water meeting the Objectives of Scottish Ministers.

We will collaborate with the Scottish Government's Investment Group to revise the change process for adjusting Scottish Water's investment programme.

CONSULTATION QUESTION

- To what extent do you agree that our proposals provide the required level of flexibility for Scottish Water's investment programme, while ensuring that Scottish Water remains accountable for delivery?

[6] We define a programme as comprising investment that share the same characteristics, involves the delivery of the same group of investment outputs, involves repeatable work of similar construction requirements and risk profiles and the location of the investment is not known.

Together with Scottish Water and Consumer Scotland, we are evolving the approach to involving customers in the Strategic Review of Charges. Our approach will build on our experience in previous SRC periods ensuring that customers are placed at the heart of the decisions we and Scottish Water make.

We will place full ownership on Scottish Water to develop its business plan and demonstrate that customers' priorities are appropriately reflected. By extension, this will ensure that our Final Determination of charges commands the support of customers and communities.

Our approach will involve establishing a multi-stakeholder research coordination group to design and implement a comprehensive customer research programme. This programme will focus on understanding strategic prioritisation and customers' acceptance of Scottish Water's business plan.

We will also require Scottish Water to ensure a Customer Challenge Group provides additional assurance on the quality of Scottish Water's engagement and research, and the extent to which customer priorities and research is reflected in the business plan.

A tripartite agreement between WICS, Scottish Water and Consumer Scotland will set out key principles underpinning the approach to customer involvement in SRC27:

- **Legitimacy**: Customer research is well designed, comprehensive, robust, unbiased, independent and follows best practice. Scottish Water's business plan reflects visibly and credibly customer views including explaining how those views have been has incorporated in the business plan.
- **Empowerment**: Customers and communities will be empowered by setting a clear expectation on Scottish Water to take ownership of its business plan and charges and demonstrate that both command customer support.
- **Challenge**: Scottish Water will be challenged robustly to demonstrate that plans are reflective of customer expectations through an independent group.
- **Collaboration**: Effective coordination and co-design of customer research building on the principles of Evidence Based Research.

CONSULTATION QUESTION

- Do you support our proposed approach on customer engagement? Why?

YOUR VIEWS

We value your input on our proposals to improve the regulatory framework for SRC27. We are inviting responses to this consultation by 12pm on 9th October 2024.

Your feedback is crucial in shaping our overall regulatory approach and the future of the water industry in Scotland. This consultation is an opportunity for you to share your views and help us ensure that the regulatory framework enables Scottish Water to meet the needs of customers, communities, the environment and all other stakeholders.

WHY YOUR FEEDBACK MATTERS

Influence decision-making

Your views will help us finalise our approach to determining charges for the regulatory control period 2027-33. This will ultimately impact Scottish Water's future strategy and decisions and the future of the water industry in Scotland.

Improve the water industry

You can help us identify areas where improvements can be made to the regulatory framework that better serve current and future generations of customers.

Enhance accountability

Your feedback will help us hold Scottish Water accountable for delivering efficient and effective services in the years to come.

HOW TO PARTICIPATE

Your feedback is vital to ensuring our regulatory framework enables Scottish Water to provide high-quality services at a reasonable price. We encourage you to take a few moments to share your thoughts and contribute to the future of Scotland's water industry.

Please respond by completing our online consultation form.

If you are unable to respond using our online form, please complete the respondent form and send via email to (enquiries@wics.scot) or by post to:

Water Industry Commission for Scotland (WICS)
First Floor
Moray House
Forthside Way
Stirling
FK8 1QZ

You may wish to learn more about how we will handle personal data you share with us as part of this consultation. You can find out more from our consultation transparency statement which is available on our website.

Thank you for your participation and support.

CONTINUED ENGAGEMENT THROUGHOUT SRC27

You will have additional opportunities to engage with us and other stakeholders. We will continue to ask your views and incorporate your feedback as we progress through the SRC27 process.

Table 1: Timeline for SRC27

Milestones	Dates
Close of draft methodology consultation	9 October 2024
Final methodology published	12 December 2024
Draft Ministerial Objectives and Principles of Charging	January to October 2025
Scottish Water's business plan	26 February 2026
Draft Determination of charges consultation	30 June 2026
Draft Determination of charges consultation closes	1 September 2026
Final Principles of Charging	September 2026
Final Ministerial Objectives	October 2026
Final Determination published	29 October 2026

1. Introduction to the methodology

1.1. The draft methodology and consultation

The Water Industry Commission for Scotland (WICS) is the economic regulator of Scottish Water. Our role involves setting caps on the charges that Scottish Water raises from its customers, ensuring that customers pay no more than necessary and receive value for money from the services delivered by Scottish Water. We perform this role through a transparent and consultative process known as the Strategic Review of Charges. Throughout this process, we work in close partnership with other organisations in the water industry. We also seek to ensure that customers are engaged throughout. This collaborative approach ensures that the charge caps we set command customers' support and allow Scottish Water to deliver the policy objectives of the Scottish Ministers.

The next Strategic Review of Charges will set charge caps for the six-year period from 1 April 2027 to 31 March 2033. This methodology document provides our proposed approach for how we will set charge caps. Our approach has developed and evolved over successive reviews, with each review delivering greater focus on customers, communities and the environment.

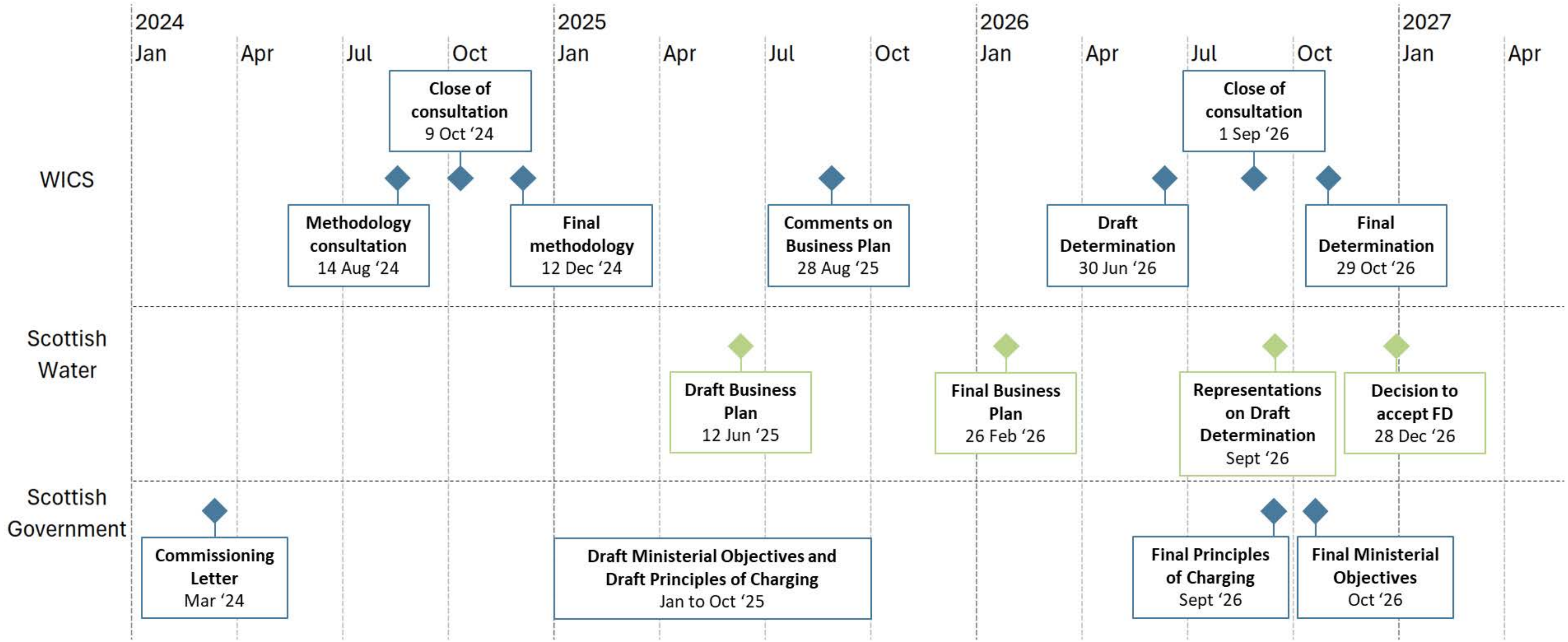
We welcome responses to our proposals by **9th October 2024**. We would like to hear views from across the water sector, including Scottish Water, licensed providers, household and non-household customers, consumer bodies, other regulators, environmental organisations, companies involved in the supply chain and any other organisation or individual interested in the water sector. Respondents can provide their feedback through the consultation page on our website.[7] We intend to publish an overview of the responses received.

1.2. Timeline for the Strategic Review of Charges 2027-2033

The responses to this consultation will help shape our final methodology, which we will publish in December 2024. Figure 2 shows this milestone in the context of the proposed timeline for the Strategic Review of Charges from 1 April 2027 to 31 March 2033 (SRC27).

[7] WICS *'Consultations'* webpage is available at https://wics.scot/consultations

Figure 2: Timeline for SRC27



2. Overview of the water industry

2.1. Overview of chapter

This chapter provides an overview of the water industry in Scotland. It sets out:

- the organisations involved in the water industry (section 2.2);
- the rationale for economic regulation (section 2.3);
- our role as economic regulator (section 2.4); and
- the benefits that the overall framework has delivered for customers (section 2.5).

2.2. The water industry in Scotland

Scottish Water is responsible for providing water services to around 2.6 million households and wastewater (covering the removal of foul wastewater and surface water drainage) services to around 2.5 million households, which covers 98% and 94% of the population in Scotland respectively.[8] Scottish Water also acts as a wholesaler of these services to licenced providers in the non-household retail market, which was introduced in 2008. The non-household retail market was a world first in terms of allowing businesses, industrial users, charities and the public sector to choose their water and wastewater supplier.

Scottish Water is publicly owned, which means that any surpluses it generates are reinvested in maintaining and improving services to the benefit of customers in Scotland.

The water industry involves several other organisations, each with their own roles and responsibilities. Figure 3 shows these organisations, followed by a summary of the role that they play in the industry.[9]

[8] See A tables of Scottish Water's Annual Return for 2022-2023. The percentage of the population connected to water and wastewater is based on Scottish Water's reported population in A tables, table A4 divided by the latest estimate of the total population of Scotland reported by the National Records of Scotland of 5,447,700 in mid-2022. National Record of Scotland (2024), '*Mid-2022 Population Estimates Scotland*'.

[9] Additional information on the roles of the industry stakeholders is available online at: Scottish Government, '*Water industry governance*', webpage.

Figure 3: Water industry stakeholders

- The Scottish Government sets the overall policy objectives for the water industry. It also acts as owner of Scottish Water on behalf of the people of Scotland and lender to Scottish Water, enabling additional investment in water, wastewater and drainage services.
- The Water Industry Commission for Scotland (WICS) is the economic regulator of the Scottish water industry. We are responsible for setting charge caps, monitoring Scottish Water's performance and overseeing the orderly functioning of the non-household retail market.
- The Drinking Water Quality Regulator for Scotland (DWQR) ensures that Scottish Water complies with its duties in respect of public drinking water supplies in Scotland. It does this through monitoring Scottish Water's compliance with drinking water quality standards and advising on future investment priorities in respect of public supplies. It also supervises Local Authorities' enforcement of regulations over private water supplies in Scotland, which serve around 3% of the population.
- The Scottish Environment Protection Agency (SEPA) is the environmental regulator in Scotland with a remit that goes beyond the water sector. Within the water sector, it has a wide-ranging role that involves monitoring, reporting and enforcement in relation to the quality of the water environment in Scotland and advising on future investment priorities.
- Consumer Scotland is the levy-funded advocacy body for the water sector in Scotland. Established by the Consumer Scotland Act 2020, Consumer Scotland is accountable to the Scottish Parliament. It works to embed positive consumer outcomes and engagement with consumers across all aspects of service delivery in the water industry, across both the household and non-household markets. This includes affordability of services, how water and wastewater services can contribute to a transition to net zero and how services should be adapted to mitigate the impacts of climate change.[10]

[10] Consumer Scotland (2023), *'Consumer Scotland Work Programme 2023-24'*, 29 March 2023.

- The Scottish Public Sector Ombudsman (SPSO) acts as the final stage for handling customer complaints for public sector bodies and departments.

Appendix 1 provides further detail on the organisations involved in the water industry in Scotland.

The clarity of roles and responsibilities of water industry stakeholders is in line with international best practice, as recognised by the international Organisation for Economic Cooperation and Development (OECD) in their Principles on Water Governance.[11] Having clarity over each of these roles helps to ensure that the industry works in partnership to understand the challenges and build consensus on the appropriate way forward. One example of this partnership approach is the Scottish Government Investment Group (SGIG), which involves each of the industry stakeholders in Figure 3 above. The role of the SGIG is to ensure that the water industry delivers the objectives that Scottish Ministers set.[12]

In addition to the Scottish Government and the different regulators discussed above, further key stakeholders include the licenced providers who participate in the non-household retail market. The Water Services etc. (Scotland) Act 2005 introduced a retail market in Scotland in April 2008 by opening the non-household water and sewerage market up to competition, allowing non-household customers to choose their licensed provider. These non-household customers comprise businesses, industrial users, public sector organisations and charities. The market participants are:

- **Scottish Water** continues to operate and maintain the water and wastewater network and provides wholesale services to licensed providers.
- **Licensed providers** are responsible for performing the retail functions for which they are licensed[13] and are required to comply with a suite of market codes and licence requirements. Licensed providers are responsible for collecting water, sewerage (standing, volumetric and any unmeasured charge where a meter cannot be installed) and drainage charges (where applicable) from non-household customers, and remain liable for these charges to the wholesaler, Scottish Water.
- These **non-household customers** comprise businesses, industrial users, public sector organisations and charities.
- The **Central Market Agency** (CMA) administers the retail market systems used by Scottish Water and licensed providers on a daily basis. This includes information regarding meter readings, transfer requests, the licensed providers that serve each non-household customer in Scotland, including the calculation of the wholesale charges that licensed providers owe Scottish Water.

[11] OECD (2015), *'OECD Principles on Water Governance'*.
[12] Scottish Government (2021), '*Water industry: governance note 2021 to 2027*', 23 November 2021.
[13] Retail services are limited to customer-facing activities such as meter reading, managing billing and payment arrangements, bad debt management, and customer enquiries and complaints. Some retailers offer additional value-added services such as advice on water efficiency and management of wastewater discharges.

- **WICS** oversees the orderly functioning of the non-household retail market.

Appendix 1 provides further information on the non-household retail market.

Several other organisations are also involved or have an interest in the water industry including:
- suppliers and contractors (known collectively as the 'supply chain') that support the efficient delivery of Scottish Water's operations and capital investment across Scotland;
- research institutes; and
- the third sector, which includes charities, social enterprises, non-government organisations (NGOs) and voluntary groups.

2.3. The rationale for economic regulation

There are two key characteristics that mean the water industry benefits significantly from economic regulation.

CHARACTERISTIC 1: LIMITED SCOPE FOR COMPETITION

Delivering water, wastewater and drainage services requires a large and complex asset base. It involves a vast network of underground pipes, storage facilities and above-ground treatment facilities (an asset base worth over £90 billion in Scotland).[14] These upfront costs make it impractical for new companies to enter the water industry and compete with the current provider. As such, the water industry is described as a natural monopoly, meaning that only one company provides the service to customers at any point in time. Without regulation, the monopoly company would have significant control over charges and service quality, which could lead to higher costs and lower services levels for customers.

CHARACTERISTIC 2: THE NEED TO THINK LONG TERM

Water, wastewater and drainage infrastructure can continue to provide services to customers for decades, if not centuries, provided they are adequately operated and maintained. This means that decisions taken today about how the infrastructure is maintained, and financed, has a marked impact on future generations of customers. It is possible, and perhaps tempting when looking over a short timeframe, to reduce charges in any year or regulatory period by reducing maintenance in the water industry or borrowing more than may be prudent. Such an approach is undesirable

[14] Gross MEAV (Modern Equivalent Asset Value) as reported in Scottish Water's Annual Return for 2022-23, H tables.

because not only does it increase bills for future customers, but it also increases the whole life cost of providing the services.

Economic regulation plays an important role in the context of these two characteristics through:

- setting efficiency challenges for the company to either reduce its costs and/or improve its levels of service which it might not have the incentive to do in the absence of competition;
- promoting the interests of customers by setting charge caps (i.e. limiting the company's allowed revenue) and holding the company to account for delivery; and
- implementing the first two elements in a way that ensures the industry remains financially resilient and maintains its assets appropriately, to avoid a situation where costs are being unduly passed on to future customers.

Through performing this role, economic regulation provides essential discipline and oversight of the water industry, ensuring sustainable and reliable services for current and future customers.

2.4. Our role as economic regulator

WICS is the economic regulator of the water industry in Scotland. Our statutory duty is to promote the interests of current and future customers, and we achieve this by:[15]

- setting caps on Scottish Water's charges for household customers and on wholesale charges for the licensed providers that serve non-household customers through a process known as the Strategic Review of Charges;
- monitoring Scottish Water's performance against the commitments and targets made at the time of setting charge caps and holding it to account for this performance through our performance report; and
- overseeing the orderly functioning of the non-household retail market in Scotland.

Appendix 1 provides further information on our activities.

2.5. The benefits of economic regulation

The overall governance of the water industry in Scotland and our approach to economic regulation has helped bring significant benefits to customers over the past two decades. For example, the average annual household bill is around £125 lower than it would have been in the absence of the efficiencies Scottish Water has achieved. Figure 4 summarises the Scottish water industry's current position and the journey of the industry over the past two decades. It compares Scottish Water to

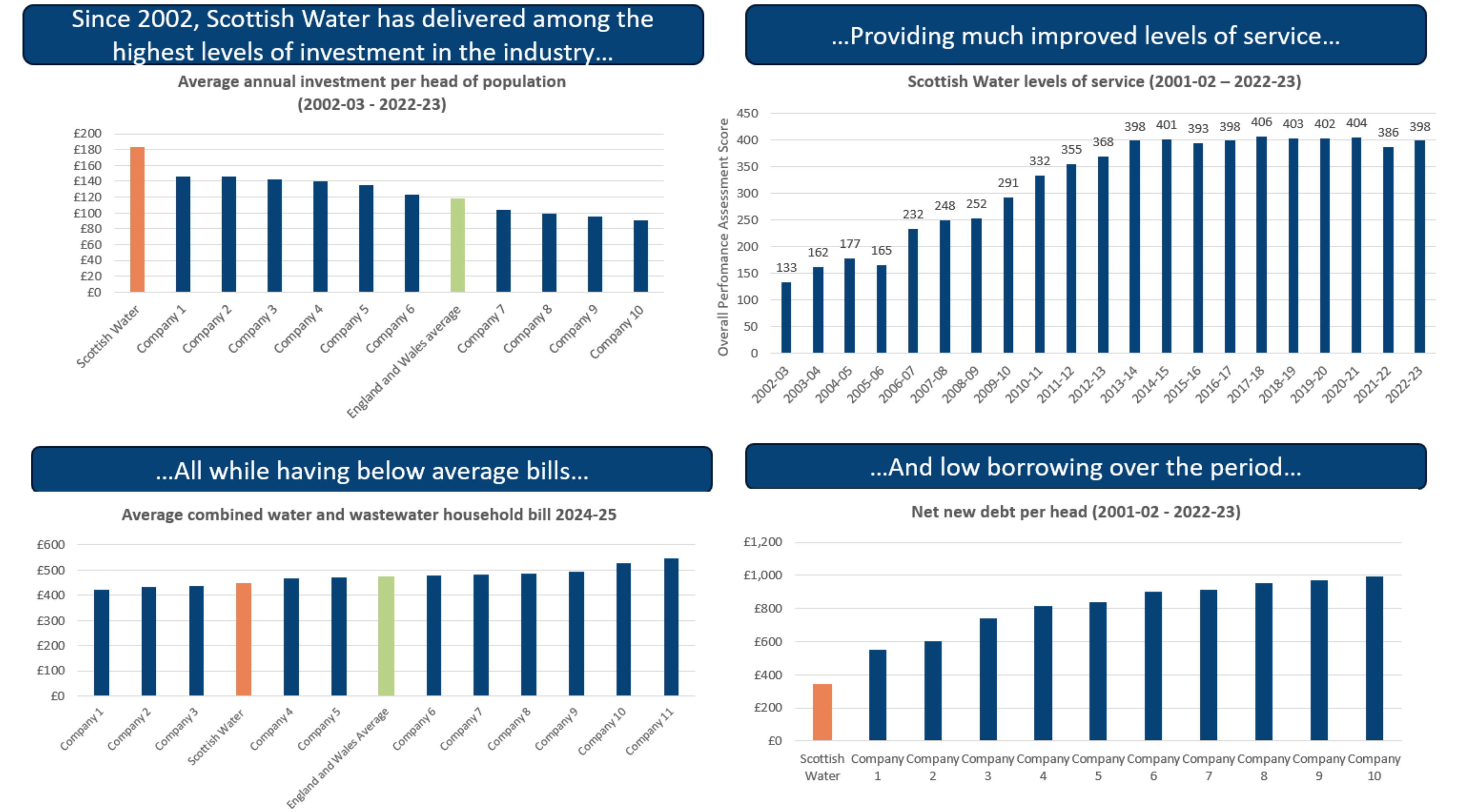
[15] Our statutory duties are set out in the '*Water Services etc. Scotland Act 2005*'.

the water and wastewater companies in England and Wales on investment, average household bills and new borrowing raised since 2001-02.[16]

Scottish Water has made significant progress since the introduction of economic regulation and has considerably improved its performance. However, our regulatory approach must continue to evolve to ensure Scottish Water can make further improvements and deliver best value for customers in Scotland.

[16] Information on the companies in England and Wales is from Ofwat (2022), *'Long-term data series of company costs'*, 21 November 2022. Discover Water (2024), *'Annual bill'*, webpage. The information on borrowing over the period is based on the change in net debt between 2002-03 and 2022-23 from Ofwat's June Return reporting requirements and for 2002-03 and the Annual Performance Reports (APRs) of the water companies in England and Wales for 2022-23.

Figure 4: Summary of the performance of the water industry in Scotland.



3. Overview of the Strategic Review of Charges

3.1. Overview of chapter

As outlined in the introduction, the next Strategic Review of Charges involves setting charge caps for the six-year period from 1 April 2027 to 31 March 2033 (SRC27).

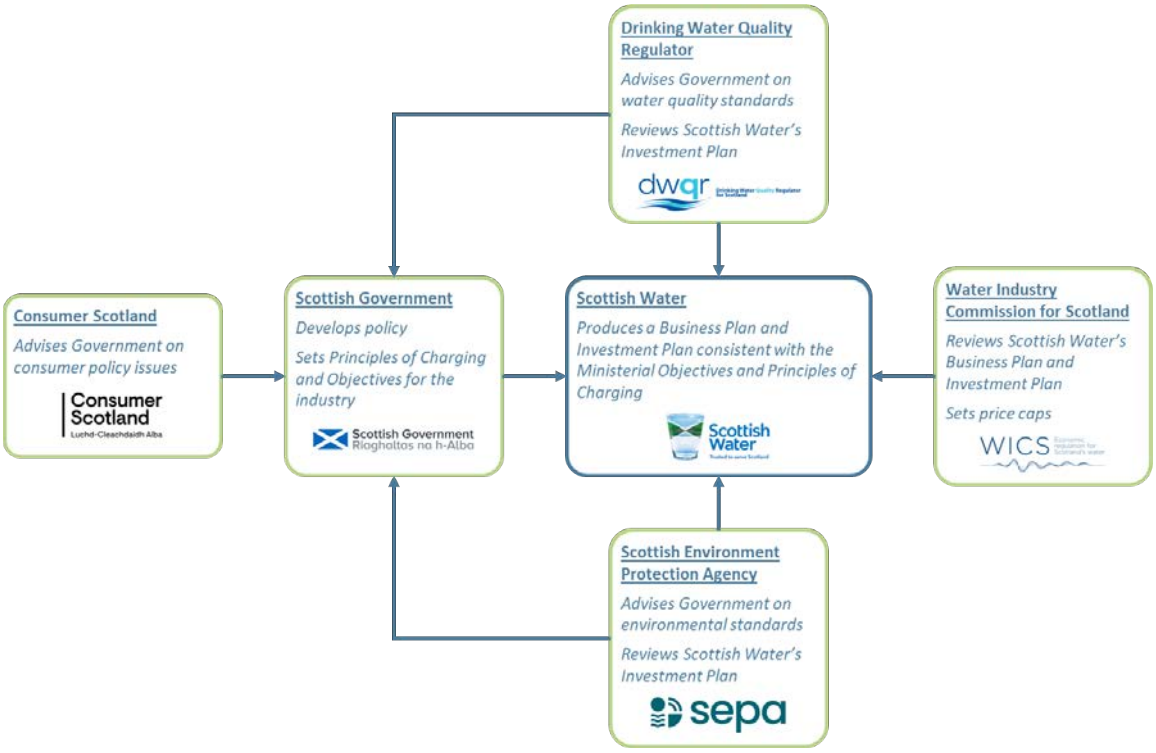
This chapter provides more detail on the Strategic Review of Charges process. It sets out:

- the role of stakeholders in the process (section 3.2); and
- the key elements of the process (section 3.3).

3.2. The role of stakeholders in the Strategic Review of Charges

In conducting a Strategic Review of Charges, we work constructively with Scottish Water and in partnership with the water industry stakeholders outlined at the start of chapter 2. These partnership arrangements have developed and evolved over successive reviews. Under these arrangements, each of the water industry stakeholders have specific roles and responsibilities, as shown in Figure 5.

Figure 5: Overview of each organisation's role in the SRC process



3.3. The key elements of the Strategic Review of Charges process

The Strategic Review of Charges process has several key milestones:

- a Commissioning letter from Scottish Ministers that commences the Strategic Review of Charges process and sets the duration of the regulatory period;
- a Statement of Objectives and Principles of Charging from Scottish Ministers that confirms the overall policy objectives for the water industry in Scotland;
- a methodology from WICS that sets out how we will set charge caps for the regulatory period;
- a proposal from Scottish Water for charge caps and investment for the regulatory period; and
- our Draft and then Final Determination of charges, which sets charge caps for the regulatory period.

Each key milestone is covered in turn. We also provide an overview of the submissions that Scottish Water provides following the Strategic Review of Charges.

COMMISSIONING LETTER

Scottish Ministers formally commence the Strategic Review of Charges by issuing a Commissioning letter to WICS. Through the Commissioning letter, Ministers set the duration of the regulatory period, the preferred approach for the Strategic Review of Charges and a high-level timeline.

STATEMENT OF OBJECTIVES AND PRINCIPLES OF CHARGING

Following the Commissioning letter, Scottish Ministers then set the overall policy priorities for the water industry. This policy is provided in the form of two statements:

- **Statement of Objectives of the Scottish Ministers**: covering the outcomes that the water industry is required to meet.[17]
- **Ministers' Principles of Charging**: covering how services are paid for and by whom and the charging arrangements to apply.[18] It sets out the principles that should be followed in deciding the tariffs paid by customer groups for specific services, including eligibility for discounts and the level of those discounts. The Principles of Charging also sets out the maximum amount of lending Ministers are prepared to make available to Scottish Water over the period.

Industry stakeholders advise the Scottish Government on both documents, which are then subject to statutory consultation.

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[17] Scottish Government (2020), *'The Scottish Water (Objectives: 2021 to 2027) Directions 2020'*, 7 December 2020.
[18] Scottish Government (2020), *'Principles of Charging 2021-27'*, 7 December 2020.

METHODOLOGY

Our methodology sets out how we will set charge caps in the Strategic Review of Charges. It provides the approach for the Strategic Review of Charges and a detailed timeline based on the Commissioning letter.

SCOTTISH WATER'S PROPOSALS

Following our methodology, Scottish Water will prepare proposals for how it plans to meet the Statement of Objectives for the six-year period in a manner consistent with the Principles of Charging for the industry. These proposals cover charge caps, investment, the scope for efficiency, and targets for levels of service. In previous Strategic Review of Charges, Scottish Water provided this information in the form of a business plan and in SRC21, Scottish Water provided a much higher-level strategic plan. Chapter 6 details our expectations in this area.

WICS' DRAFT AND FINAL DETERMINATIONS

We then set charge caps which are based on our assessment of the lowest reasonable overall cost incurred by Scottish Water in delivering the Statement of Objectives, consistent with the Principles of Charging for the industry.

To set these charge caps, we review Scottish Water's plan for efficiency and effectiveness, estimating the cash that Scottish Water requires over the six-year period to deliver the required investment.

Once we publish our Final Determination, Scottish Water has 60 days to decide whether to accept the Determination or ask WICS to refer the Determination to the UK Competition and Markets Authority for redetermination.

SUBMISSIONS FOLLOWING THE STRATEGIC REVIEW OF CHARGES

Each year during the regulatory period, Scottish Water then submits a Charges Scheme for household, retail and wholesale charges to us for approval. We approve the Charges Scheme if it is consistent with the charge caps set out in the Final Determination and Ministers' Principles of Charging.

Scottish Water would also produce a delivery plan setting out how it planned to meet the requirements of the Final Determination. It covered areas such as financial forecasts, the detail of the investment programme (including tangible deliverables or 'outputs' from investment, project costings and dates the projects would reach the interim investment milestones) and levels of service forecasts. Each year, Scottish Water would refresh its delivery plan to reflect updates to its financial forecasts and investment programme and maintain the linkage to the requirements of the Final Determination.

4. Setting the scene for SRC27

4.1. Overview of chapter

This chapter provides the background and context for SRC27. It sets out:

- the challenges and opportunities within the water industry (section 4.2);
- our approach for the Strategic Review of Charges 2021 to 2027 (SRC21) (section 4.3);
- developments following SRC21 (section 4.4); and
- expectations from the Commissioning letter for SRC27 (section 4.5).

4.2. Challenges and opportunities within the water industry

Scottish Water and the broader industry face several challenges, including mitigating and adapting to the impacts of a changing climate, managing the risks associated with an ageing asset base, and meeting stakeholder and societal expectations for drinking water quality and environmental protection. There are also opportunities such as playing a role enhancing natural and social capital. This section considers these challenges and opportunities in more detail.

THE CHALLENGES OF A CHANGING CLIMATE ON THE INDUSTRY

Climate change poses both a significant mitigation challenge and an adaptation challenge for Scotland. The mitigation challenge relates to the need to flatten the rise of global temperatures by reducing greenhouse gas emissions. The adaptation challenge describes the need to respond to the ways in which the climate has and continues to change. Recognising both challenges, the Scottish Government became one of the first national governments to declare a climate emergency in 2019.[19]

Mitigation challenge

Scottish Ministers set Scotland an ambitious target to achieve net zero emissions of all greenhouse gases by 2045. Scottish Water has a target to reach that goal five years earlier by 2040. This target of net zero emissions by 2040 applies both to operational emissions and to all emissions associated with the capital investment programme. On the former, Scottish Water has set itself the additional challenge of reducing operational emissions by at least 75% by 2030.[20]

Given the asset intensive nature of the industry, Scottish Water can play a key role in contributing to carbon emission reduction in Scotland. There are significant opportunities for Scottish Water to reduce emissions, for example, by using its vast land estate for carbon sequestration (e.g. peatland

[19] Scottish Government (2019), *'The Global Climate Emergency - Scotland's Response: Climate Change Secretary Roseanna Cunningham's statement'*, 14 May 2019.
[20] Scottish Water (2020), *'Net Zero Emissions Routemap'*, 13 September 2020.

restoration, tree planting) and developing more sustainable energy sources as a byproduct of its activities (e.g. heat capture from wastewater treatment processes).

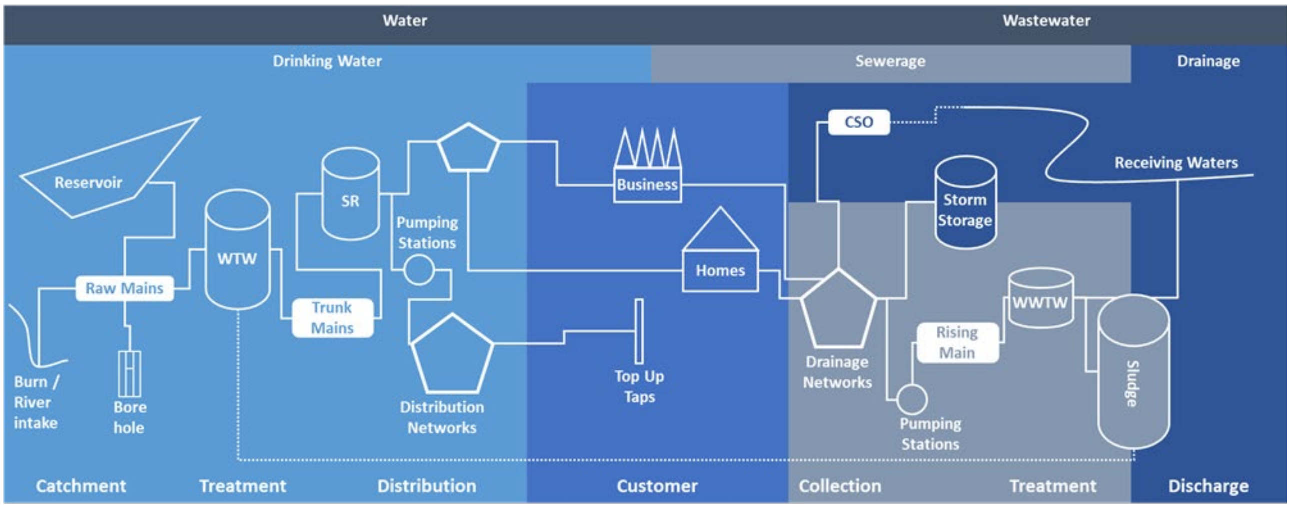
Adaptation challenge

Climate change is bringing weather patterns that place increasing and significant pressure on the water industry and the essential services it provides. Increasing temperatures are impacting the quality and quantity of the water that can be taken from the environment for drinking water. Intense periods of rain increase the risk of flooding, impacting homes, businesses and essential services. This means there is a need to consider the drainage of towns and cities to address flooding and reduce the knock-on economic impacts.[21] The extent of the climate change adaptation challenge facing the water industry has also been identified by the Climate Change Committee, which highlights that further work is required in this area.[22] The industry must consider how it will evolve to address the impacts of climate change including how this will impact future investment and customer charges.

THE CHALLENGE OF MAINTAINING AN AGEING ASSET BASE

Scottish Water's asset base has a replacement value of some £90 billion, which includes around 54,000km of sewers and 49,000km of water mains.[23] As illustrated in Figure 6, providing water, wastewater and drainage services relies on a complex system of pipes, sewers and treatment facilities. Scottish Water needs to manage effectively its asset base, replacing assets at the right time, and taking account of the need to maintain levels of service. If these assets are not maintained regularly and replaced when appropriate, then there is an increased risk of assets failing and impacting on future levels of service.

Figure 6: Water industry activities



[21] Scottish Water (2024), *'Climate Change Adaptation Plan 2024'*, 29 February 2024.
[22] Climate Change Committee (2023), *'Adapting to climate change – Progress in Scotland'*, 21 November 2023.
[23] See H and E tables of Scottish Water's annual return 2022-2023.

Based on the value of these assets and their expected lifetimes, Scottish Water's analysis identified that levels of asset replacement may need to increase by two to three times compared to historic levels at some point in the near future.[24, 25] Industry experts within the UK have identified that the challenge of maintaining and replacing ageing infrastructure is a significant issue, which is not unique to Scotland or the water industry.[26]

ECONOMIC CHALLENGES

The Covid-19 pandemic brought major disruption, not only to Scottish Water and the wider water sector, but also to every business and household in Scotland. The economic impact of the pandemic is still being felt with many households and businesses under severe financial pressure, struggling to afford basic expenses and facing increased debt levels. There have also been inevitable impacts on Scottish Water's finances and investment delivery.

We recognise the challenges Scottish Water has faced during the current regulatory control period, especially responding to the Covid-19 pandemic, in keeping charges affordable while ensuring all customers pay their fair share for water and sewerage services.

The ongoing economic situation and cost of living crisis may continue to impact Scottish Water's ability to secure the funding it needs from customers. We expect Scottish Water to explain how it will manage these pressures whilst ensuring it can deliver the levels of investment required to maintain high quality water and sewerage services both now and into the future.

MEETING EXPECTATIONS FOR THE QUALITY OF DRINKING WATER AND THE WATER ENVIRONMENT

Safe drinking water and a healthy water environment are important to all of us. We depend on safe drinking water for our health, while a clean water environment supports our wellbeing offering amenity value and contributes to Scotland's economy including through attracting tourism. Scottish Ministers have committed to align water quality and environmental standards in Scotland with EU legislation[27], including the recast Drinking Water Directive[28] and the recast Urban Wastewater Treatment Directive[29], in the best interests of Scotland. The water industry in Scotland will need to consider how it delivers these improvements in a sustainable way that takes account of the impact of investment on greenhouse gas emissions and promotes natural and social capital.

OTHER CHALLENGES AND OPPORTUNITIES

The water industry faces several other challenges, including:

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[24] Scottish Water (2023), *'Annual Report and Accounts 2022/23: Performance and Prospects'*, 31 May 2023, p.7.
[25] WICS (2017), *'Strategic Review of Charges 2021-27: Methodology'*, 1 April 2017.
[26]Helm, D. (2023), *'Who should pay for the sewers?'*, 24 May 2023, webpage.
[27] Drinking Water Quality Regulator, '*Regulatory Framework*', webpage.
[28] European Commission, '*Drinking Water*', webpage.
[29] European Commission, '*Urban Wastewater*', webpage.

- the return of wastewater treatment works and bioresource[30] centres, currently owned and operated by third parties under private finance initiatives (PFI) arrangements[31], to Scottish Water. Scottish Water will need to consider the options for the future operation of these assets.
- ensuring that Scottish Water remains resilient to an increasing threat of cyber-attacks.[32]
- demographic trends – specifically, population growth, falling average household sizes and a gradual shift in population from the west of Scotland to the east, which can place pressures on the capacity available in the water system to accommodate new demand.
- Societal expectations have shifted to place greater importance on the natural environment. Customers and the public expect the water industry to take meaningful steps to reduce its impact on the environment.

Other opportunities facing the industry, include:
- supporting the aims of the Circular Economy Bill[33] through exploring the potential to recover resources from wastewater[34] and reduce chemical use.
- playing a role contributing to natural and social capital and helping to promote a sense of place, covering an individual's and communities' relationship with where they live and their local environment.

4.3. Our approach for SRC21

For the Strategic Review of Charges 2021-27 (SRC21), we recognised the need to adapt our regulatory approach to ensure that Scottish Water is best placed to address these challenges. Our approach was based on the principles of Ethical Business Practice and Regulation (EBP&R), which requires candour and transparency in all conversations between regulator and regulated company, and therefore reducing asymmetries of information.[35] We consider candid discussions essential to build a common understanding and consensus about the nature of challenges and how best to respond to them. Box 2 summarises the EBP&R approach adopted in SRC21.

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[30] Bioresources relates to the treatment, recovery and/or disposal of the solids, known as sludge, that remain from the wastewater treatment process (which are a valuable resource that can be used to generate renewable energy).
[31] PFI expenditure represents over 10% of Scottish Water's annual expenditure. Under these contracts, third parties operate and maintain 21 facilities across Scotland for the provision of wastewater treatment and the subsequent treatment, recovery and/or disposal of the biosolids.
[32] See for example the Guardian (2024), *''Elevated' risk of hackers targeting UK drinking water, says credit agency'*, February 2024.
[33] Scottish Government (2024), *'Circular Economy (Scotland) Bill'*, webpage
[34] Wastewater and its byproduct sludge provide a valuable bioresource (a renewable natural resource that it derived from living organisms or organic matter). There are opportunities to safely recover resources from wastewater such as the generation of energy, capturing heat from sewers and abstracting useful chemicals, metals and nutrients (phosphorus).
[35] The principles of EBP&R are set out in Hodges and Steinholtz (2017), *'Ethical Business Practice and Regulation: A Behavioural and Values-Based Approach to Compliance and Enforcement'*.

Box 2: Ethical Business Practice and Regulation

Ethical Business Practice

An organisation in which the leaders consciously and consistently strive to create an effective ethical culture where employees do the right thing, based upon ethical values and supported by cultural norms and formal institutions. It involves businesses continually demonstrating evidence of their commitment to open, fair and candid behaviours that builds and maintains the trust of its stakeholders.

Ethical Business Regulation

Ethical Business Regulation is a relationship between a business and a regulator, in which the business produces evidence of its on-going commitment to Ethical Business Practice and the regulator recognises and encourages that commitment. The approach encourages transparency and openness, and the regulated company is empowered to take ownership of its decision making. A key aspect of the approach is for the regulated company to establish and maintain the confidence of stakeholders.

How we behave as a regulator is key. We must support and encourage. It is not about regulatory capture, in fact, challenge is a key element of EBR. It is for the regulated company to explain, deliver, and demonstrate to all of its stakeholders that it is operating effectively and efficiently and for stakeholders to have more information on which to challenge in a more cooperative and supportive environment. There are demanding expectations for behaviour, with clear consequences and scope for regulatory intervention if the regulated company does not meet these expectations.

It is imperative that Scottish Water gains the confidence of WICS and other stakeholders through being transparent, and producing compelling evidence to show how it is acting in the best interests of customers and the environment. For SRC21, this has been summarised as:

Candour + analysis = confidence

Candour: Scottish Water will be balanced in what it says and what it does. Stakeholders have to be candid in their interactions with Scottish Water. There should be no surprises.	**Analysis:** Scottish Water needs to evidence the challenges and opportunities it faces. How has it prioritised? How will it deliver? How has it taken into account the views of customers and communities?

SRC21 was built upon a customer engagement approach introduced in the previous Strategic Review of Charges 2015 to 2021 (SRC15), which involved Scottish Water engaging with a Customer Forum to agree a business plan for the six-year period. The expectation was that the approach to SRC21 would be broadly similar. However, in recognition of the nature of the challenges facing the water industry, it soon evolved to become a multi-stakeholder engagement process, where Scottish Water worked in partnership with its different stakeholders to co-create a strategic plan.

An early success of this co-creation process was the development of a water sector vision, as shown in Box 3 below.

Box 3: Sector vision[36]

The water sector vision

- Scotland's water sector will be admired for excellence, secure a sustainable future and inspire a Hydro Nation.
- Together we will support the health and wellbeing of the nation.
- We will ensure that all of Scotland gets excellent quality drinking water that people can enjoy all of the time. Scotland's wastewater will be collected, treated and recycled in ways that generate value and protect the environment.
- We will enable the economy to prosper.
- We will transform how we work to live within the means of our planet's resources, enhance the natural environment and maximise our positive contribution to Scotland achieving net zero emissions.
- We will involve and inspire Scotland’s people to love their water and only use what they need.
- We will promote access to the natural environment and encourage communities to enjoy and protect it.
- We will be agile and collaborate within the sector and with others to be resilient to the challenges which will face us.
- We will keep services affordable by innovating and delivering the greatest possible value from our resources, helping those who need it most.
- We will serve all customers and communities in a way that is fair and equitable to present and future generations.
- We are a vital part of a flourishing Scotland.

Following from the sector vision, Scottish Water developed a high-level strategic plan.[37] The plan set out three outcomes that would enable Scottish Water to achieve the vision for the sector. These outcomes were:

- Service excellence – meeting evolving customer expectations while dealing with an aging asset base and adapting to a changing climate.

[36] Scottish Water, *‘Water Sector Vision’*, webpage.
[37] Scottish Water (2020), *‘Strategic Plan – A Sustainable Future Together’*, 03 February 2020

- Beyond net zero emissions – showing leadership in mitigating climate change and enhancing Scotland’s natural environment.
- Great value and financial sustainability – customers should receive great value, now and in the future, and Scottish Water will continue to be financially sustainable.

We set our Draft and Final Determination based on top-down investment allowances for asset replacement investment, enhancement and growth. We expected the detailed bottom-up evidence to follow through the then investment planning and prioritisation group (IPPG, which is now part of the Scottish Government Investment Group, SGIG) which would define the investment programme throughout the regulatory period.[38] This marked a departure from the previous approach, which was based on forward-looking bottom-up evidence of the required investment programme.

We also set an expectation that Scottish Water would develop a strategy for how it would prioritise its investment.[39] In the strategic plan, Scottish Water committed to publishing a delivery plan. The delivery plan was to set out the plans and priorities for the first part of the regulatory period, including milestones and targets.[40] This was designed to provide visibility of future investment requirements on a rolling basis. The delivery plan was to be updated every two years and the performance report was to be published by Scottish Water each year. While Scottish Water produced an initial delivery plan covering the first two years of SRC21, it did not update this for subsequent years. On reflection, we consider that we could have set clearer expectations in this area, especially recognising the developments following the Final Determination.

4.4. Developments following SRC21

SCOTTISH WATER’S PROGRESS DURING THE REGULATORY PERIOD

SRC21 was concluded during the COVID-19 lockdowns, after which the UK entered a period of high inflation. During this period, a number of factors – including volatile and high energy prices, high economy-wide inflation, and resulting increases in interest rates – placed and continues to place significant pressure on the cost of living for many of the households and businesses that Scottish Water serves.

The more flexible regulatory framework introduced for SRC21 enabled Scottish Water to respond to these factors by reprofiling charges and ease the financial pressure of individuals and families across Scotland. In the first three years of the regulatory period, Scottish Water has increased charges by less than the annual average cap of CPI inflation + 2% that we allowed for in the Final Determination. However, a consequence of reprofiling charges is that the cash that Scottish Water has available for investment is lower than was forecast at the time of the Final Determination.

[38] WICS (2020), *‘Strategic Review of Charges 2021-27: Final Determination’*, 10 December 2020, pp.15-16.
[39] WICS (2020), *‘Strategic Review of Charges 2021-2027: Draft Determination’*, 8 October 2020, p.47.
[40] Scottish Water (2021), *‘Delivery Plan 2021/22 – 2022/23 – A sustainable future together’*, 17 August 2021.

Furthermore, the high inflationary environment, and in particular high construction price inflation, has meant that the cash available for investment can pay for fewer capital projects (a reduction in purchasing power).

These factors have led to uncertainty over the delivery of the investment that was allowed for in our 2021-27 Final Determination. We have therefore been working with Scottish Water to understand the impact on the investment programme for the 2021-27 regulatory period. This has involved writing to Scottish Water to ask for further information on the implications of this lower funding on the ability of Scottish Water to meet the Statement of Objectives of the Scottish Ministers. We also asked how Scottish Water will improve its reporting and evidencing of future investment needs.[41]

THE SCOTTISH GOVERNMENT'S POLICY DEVELOPMENT WORK

Another important development following SRC21 relates to the Scottish Government's water industry policy development work which is currently underway.

The Scottish Government is currently developing policy that will determine the guiding principles for the water industry as it addresses longer-term challenges including climate change adaptation and mitigation. The policy work focuses on equipping the water industry with the necessary tools and legislation to ensure that essential water, wastewater and drainage services can continue to be provided in a changing climate. In November 2023, the Scottish Government consulted on the overall policy principles, as summarised in Box 4 below.

[41] A letter titled *'Reporting quality and completeness'* was sent to Scottish Water on 13 December 2022.A second letter, *'Reporting quality and completeness improvement plan'*, was sent to Scottish Water on 21 March 2023.

Box 4: Scottish Government policy principles[42]

Scottish Government policy principles

- Water is a precious resource – it is essential for life. It supports our lives, agriculture and businesses (including distilleries and manufacturing etc.) and supports our environment. We will need to consider the water needed to water crops to maintain food supplies, or make different choices about the crops we grow, support tourism and to support new lower carbon industry, such as hydrogen production. At the same time, we must ensure we have enough water to provide drinking water supplies which are essential for public health and to protect Scotland's environment.
- Safe drinking water is important to our health. We need to make sure that we are able to provide a reliable supply of water during dry periods and act to protect the water supplies quickly during these times. We also need to make sure that the water that reaches our taps remains safe to drink, which requires us to consider all the possible risks.
- The changing climate means we are seeing more extreme weather events such as periods of very heavy and/or intense rainfall which can lead to spills from drainage systems to the environment and/or cause flooding to homes and businesses. We need to make greater changes in the way we manage the consequences of extreme weather events as their frequency increases.
- Many of Scotland's wastewater treatment works are located along the coast and are vulnerable to sea level rises. This means that we need to change our approach to managing our wastewater network. Unless we respond to the changing climate by adapting our sewage services now, the costs to households, businesses and the environment arising from floods from sewers will be much higher. We also want to maximise the opportunity to use resources from wastewater and to make it easier to adopt new and future technologies.

These principles will underpin the water industry's approach to providing water, wastewater and drainage services for decades to come. This work brings stakeholders together as 'Team Scotland' to shape the future of the water industry. In developing supporting analysis for the Scottish Government, WICS and Scottish Water have already proven the efficacy of this 'Team Scotland' approach. We will look to continue the 'Team Scotland' approach which builds on the principles of Ethical Business Practice, adopted in in SRC21. We will also ensure that our approach to the Strategic Review of Charges can adapt to any changes proposed through the policy development work, which we expect to be reflected in the Statement of Objectives.

4.5. The Commissioning letter for SRC27

[42] This box summarises the principles set out in the following document: Scottish Government (2023), *'Water, wastewater and drainage policy: consultation'*, 21 November 2023.

The Scottish Ministers' Commissioning letter is set in the context of the three missions set out in the First Minister's Policy Prospectus:[43]

- Equality: Tackling poverty and protecting people from harm;
- Opportunity: A fair, green and growing economy; and
- Community: Prioritising our public services.

An extract from the Commissioning letter is shown below. Appendix 2 provides the full Commissioning letter.

Box 5: Extract from the SRC27 Commissioning letter

Ministers request that the Commission undertakes a Strategic Review of Charges for the six-year period 2027 to 2033. The Final Determination should be published by 31 October 2026 at the latest to ensure time for Scottish Water to prepare its charging schemes and submit them to the Commission for its approval, and then implement them in time for issuing via Council Tax bills in March 2027. Ministers would welcome sight of a Draft Determination by June 2026, but are open to discussion on this timing.

Ministers request that the Draft Determination sets out a range of possible charge paths for both the domestic and non-domestic sectors for the services provided by Scottish Water: drinking water, sewerage and drainage. Ministers want the Review to provide them with the necessary information to appreciate the progress towards objectives and the level of risk of service failure associated with different levels of investment in the short, medium and long terms. In calculating the range of charge paths, for planning purposes the Commission should assume that similar levels of lending to 2021-27 period will be made available (around £1.03 billion).

As the industry is aware, Scottish Ministers recently consulted on policy proposals (Nov-Feb 2024) to equip the Water Industry with the necessary powers to ensure that essential water, wastewater and drainage services can continue to be provide in a changing climate. The Review must remain cognisant of ongoing policy development and any resulting legislative changes. Ministers will confirm the extent of changes required in their final Ministerial Objectives.

Ministers request that the Commission ensures, together with water industry stakeholders, that consumers, communities and the environment are placed at the heart of this Review. They expect that the consumers are engaged throughout this process and that the Commission can demonstrate that Final Determination commands consumers' support.

[43] First Minister (2023), '*Equality, opportunity, community: New leadership - A fresh start*', 18 April 2023.

5. Principles for the Strategic Review of Charges 2027-33

5.1. Overview of chapter

This chapter provides the principles that underpin our proposed approach for SRC27. It sets out our view of:

- what a successful approach to delivering the sector vision could look like (section 5.2);
- what works well (section 5.3);
- what we could do differently for SRC27 and why (section 5.4); and
- our proposals (section 5.5).

5.2. Delivering the industry vision

In the Commissioning letter, Scottish Ministers have confirmed they will set their Statement of Objectives in the context of the water sector vision and that we should continue to consider this as a set of outcomes towards which clear and demonstrable progress must be made. This section sets out our perspective on what a successful approach to delivering the sector vision could look like.

EVIDENCE AND OWNERSHIP

The high-level nature of the sector vision highlights the importance of defining what the vision means in practice and how the sector can meet the vision. Scottish Water cannot achieve the sector vision alone. It requires the support of all stakeholders, including customers and communities, to fully succeed. Building a clear understanding of how each stakeholder will contribute to the vision is crucial. This will help clarify responsibilities and ensure effective collaboration in delivering each key element of the vision.

Taking the vision forward will require that Scottish Water provides clarity on:

- its contribution to the sector vision, recognising that the sector vision is wider than Scottish Water;
- the tangible measures and milestones that will enable stakeholders to understand Scottish Water's progress towards achieving its contribution;
- the investment and nature-based solutions (references to investment throughout this document relate to both traditional capital investment and nature-based solutions) that will enable Scottish Water to achieve these tangible measures and milestones;
- the progress Scottish Water will make during the 2027-33 regulatory period, recognising the Statement of Objectives of the Scottish Ministers for 2027-33 will be an important step in the journey towards achieving the sector vision;
- when the full sector vision will be met; and

- how Scottish Water will measure and report on progress.

Success will involve Scottish Water developing a robust evidence base that underpins the sector vision and communicating this effectively to customers, communities, and key stakeholders. We expect this would require much more definition over the options for investment in the near-term six-year period. Success also involves recognising the need for flexibility in the context of long-term objectives (as other economic regulators have noted).[44] We expect this could be achieved by Scottish Water setting out a transparent and robust process for making changes to its plans for investment as further information becomes available.

We consider it important that Scottish Water takes ownership of its business plan and charges, and that both command the support of its customers and communities. This will be foundational in ensuring that Scottish Water is best placed to deliver its contribution to the sector vision in the longer term.

THE CUSTOMER VOICE

Scottish Water should be able to demonstrate that the views of customers and communities are embedded in all its decisions – regarding both its day-to-day operations, the development of plans for investment and the delivery of those plans. Increasingly, delivering outcomes such as reducing flood risk will require Scottish Water to work in partnership with customers, communities, landowners, local authorities and other agencies.

REPORTING ON PERFORMANCE

In line with the principles of EBP&R, Scottish Water should regularly and transparently report on its performance, as one way to build and maintain confidence. This would allow stakeholders to understand whether Scottish Water is performing in line with expectations and is on track to deliver the outcomes defined in the sector vision.

Scottish Water's performance reporting will be reviewed to ensure it meets the needs of stakeholders for the 2027-33 regulatory period. This will include reporting progress towards achieving its contribution towards the long-term sector vision.

As part of the framework Scottish Water will use to make changes to its plans for investment, it should set out how the changes to the investment plan outlined under evidence and ownership above will be reported to customers, communities and stakeholders.

The quality of reporting should be supported by robust assurance processes, as well as being open about any challenges or shortfalls in performance and how Scottish Water plans to address them.

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[44] See, for example, Ofwat (2022), *'PR24 and beyond: Final guidance on long-term delivery strategies'*, 06 April 2022. Ofgem (2020), *'Ofgem's Decarbonisation Action Plan'*, 03 February 2020.

5.3. What works well?

WHAT DOES A SUCCESSFUL STRATEGIC REVIEW OF CHARGES REQUIRE?

Through the Strategic Review of Charges process we work closely with Scottish Water and key industry stakeholders. These foundational elements have developed and evolved over successive Strategic Reviews of Charges. There are five key foundational elements to a successful Strategic Review of Charges:

1. **Clarity of the roles and responsibilities.** As set out in chapter 3, one of the strengths of the governance framework in Scotland is the clarity of roles and responsibilities of the water industry stakeholders in the Strategic Review of Charges process. These arrangements have developed and evolved over successive Strategic Review of Charges, and it is important to maintain this clarity in the approach to SRC27.

2. **A regulatory framework that enables openness and collaboration**. This creates the conditions to identify and address long-term industry challenges together with water industry stakeholders, moving away from a 'traditional' approach characterised by greater asymmetries of information and an adversarial relationship between regulator and regulated company.

3. **Scottish Water is set an ambitious efficiency challenge that also maintains incentives for outperformance to the benefit of customers.** This ensures that customers continue receiving value for money from the services Scottish Water provides.

4. **Defining what the regulated company will deliver in terms of commitments and targets over the regulatory period**. This ensures that the regulated entity can be held to account for delivery over the regulatory period, both in terms of delivering the investment programme and achieving the efficiency challenge over the period.

5. **A strong customer and community voice at the heart of the process.** This ensures that the outcome of the Strategic Review of Charges aligns with what customers value most. There is a role for customer involvement both in determining policy for the sector and, taking policy as a given, ensuring that the Strategic Review of Charges process delivers the best outcome for the people of Scotland.

WHAT ADDITIONAL ELEMENTS INTRODUCED FOR SRC21 WORKED WELL

We have undertaken a review of SRC21 to identify what worked well and what could be improved. The elements that worked well cover the following three areas:

Formalising the working arrangements based on the principles of EBP&R. As set out in chapter 4, the move to a new regulatory approach based on the principles of EBP&R helped to encourage a culture of openness shifting the focus of stakeholders to the long-term challenges of the industry, such as the challenge of maintaining service in the context of Scottish Water's ageing assets and Scottish Water's target to achieve net zero emissions by 2040.

Following the adoption of the principles of EBP&R in SRC21, there has been further work in this field by Professor Christopher Hodges. This work has led to EBP&R evolving into a framework of Outcome Based Cooperative Regulation (OBCR), marking a significant evolutionary step in regulatory frameworks. EBP&R primarily focused on promoting ethical integrity and transparency, laying a solid foundation of trust and accountability in business and regulatory practices. OBCR builds upon these ethical foundations by linking them directly to specific, measurable outcomes, thereby ensuring that ethical practices lead to tangible community and environmental benefits.

As the evolution of EBP&R into OBCR is a recent initiative, we will continue to monitor how the approach develops to identify the practical lessons for our regulation of Scottish Water.

Greater engagement and collaboration among the industry stakeholders. The step-change in levels of engagement and collaboration delivered significant benefits, including the development of a shared sector vision and in building a greater awareness of the challenges posed by Scottish Water's ageing asset base. The creation of the industry research coordination group was also a positive development. This facilitated more innovative research techniques, including the use of behavioural insight experiments[45] and structured dialogues with focus groups providing in depth-insight into customers' views, concerns and aspirations.[46]

The SRC21 process was peer reviewed by the international body, the Organisation for Economic Cooperation and Development (OECD).[47] The OECD reported that "while the time costs were high, some stakeholders reported that the process was "worth it" due to the immediate outcomes from SRC21, including a "no surprises" approach for some outputs with a greater degree of transparency".[48]

A more flexible investment approach. As set out in chapter 4, SRC21 involved the introduction of a new approach to developing the investment programme through the investment planning and prioritisation group (IPPG, which is now part of the Scottish Government Investment Group, SGIG).

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[45] Behavioural research tends to involve experiments which aim to understand people's 'true' or revealed preferences, by testing how they actually behave when presented with choices. The rationale for this is that someone's revealed preferences may differ from what they would report their preferences to be. See Economic and Social Research Institute (2020), *'An experimental study of attitudes to changing water charges in Scotland'*, March 2020.
[46]Ipsos Mori (2019), *'Customer views on Scottish Water's future strategy: An Ipsos Mori research study commissioned by the Customer Forum for Water'*, October 2019.
[47] OECD (2022), *'Scotland's Approach to Regulating Water Charges'*, 19 October 2022.
[48] OECD (2022), *'Scotland's Approach to Regulating Water Charges'*, 19 October 2022, p.48.

The approach builds flexibility into the investment planning process, allowing Scottish Water to respond effectively to changes in investment priorities during the regulatory period. For example, there has been increased investment aimed at improving river and bathing water quality, through Scottish Water's 'Improving Urban Waters Routemap'.[49]

5.4. What could we do differently?

WAYS OF WORKING

Whilst the collaborative approach to SRC21 was effective in creating the conditions to be open about the long-term challenges of the industry, at times it created confusion around the ownership of deliverables. For example, the 'co-creation' approach adopted for the development of the strategic plan sometimes created confusion among stakeholders about who was ultimately owning the drafting of the document.

It is important that the collaborative approach is retained, but it is also important to ensure there is a clear understanding about stakeholders' roles, responsibilities, and contributions throughout SRC27.

EVIDENCE

As set out in chapter 4, we set our Final Determination based on top-down allowances for investment, with the expectation that the evidence would follow through the IPPG (now SGIG). There is broad consensus among stakeholders that progress was slow in this area following the publication of the Final Determination.

The Commissioning letter has also asked for a range of charge paths for the services provided by Scottish Water. This will require Scottish Water to provide evidence and information on how it plans to meet the Ministerial Objectives over the regulatory period in the context of the overall sector vision. This will require Scottish Water to:

- explain what the water sector vision means in practice, covering the areas set out in section 5.2; and
- define the different options for its investment for the six-year regulatory period and beyond on a forward-looking basis.

It will also require that Scottish Water provides assurance of evidence and information. The quality of the evidence, information and assurance will be key to ensuring that the outcome of SRC27 commands the support of customers, communities and other stakeholders.

[49] Scottish Water (2021), *'Improving Urban Waters Routemap'*.

ACCOUNTABILITY

As set out in chapter 2, holding Scottish Water to account is a key part of our role and places an important discipline on Scottish Water to deliver on behalf of its customers. Our ability to hold Scottish Water to account relies on having access to timely and comprehensive information covering areas such as financial forecasts, delivery commitments and service targets for the regulatory period.

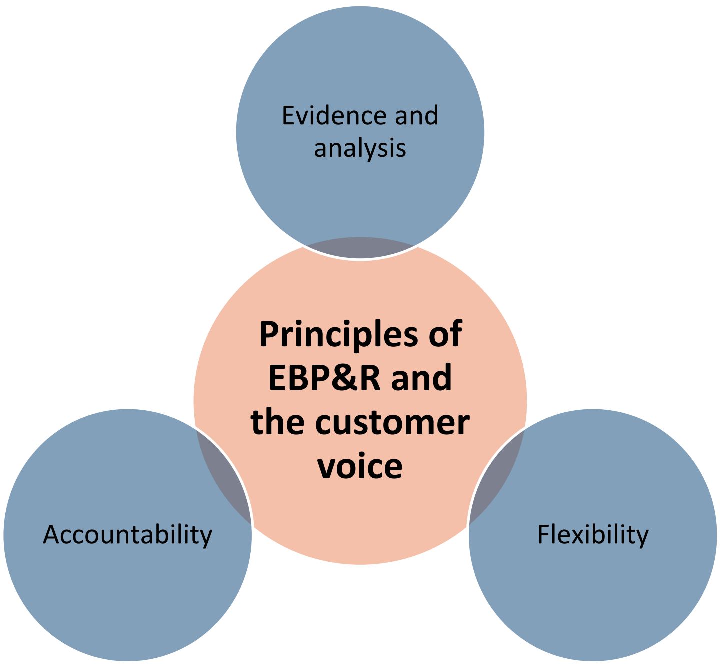
FLEXIBILITY

It is important that the industry has and retains the appropriate flexibility to adapt its approach and respond to changes given the significant uncertainties facing the sector. Scottish Water should be able to respond effectively to changes in investment priorities during the regulatory period. As set out in section 5.2, there needs to be a clear governance around changes to ensure the implications of these changes are appropriately documented and understood by stakeholders. The timeline for SRC27 should also be kept under close review to ensure it supports and takes account of the Scottish Government's policy development work (see chapter 4).

5.5. Our proposals

Taking account of the strengths of the regulatory framework to date, we propose that SRC27 will be based on the following key principles:

Figure 7: The key principles of SRC27



Embedding our commitment to work with industry stakeholders in line with the principles of **EBP&R** to encourage openness and candour, especially in respect of the challenges facing the industry and how best to respond to them. The ‘Team Scotland’ (see section 4.4) approach adopted for the Scottish Government’s policy development work builds on the principles of EBP&R and should continue for SRC27. Another key principle is ensuring that the **customer voice** is placed at the heart of the decisions taken in SRC27.

Focusing on **evidence and analysis** underpinning how Scottish Water plans to meet Scottish Ministers’ Statement of Objectives in the context of the water sector vision. We expect Scottish Water to provide a range of options for investment, including innovative and nature-based solutions to support a range of possible charge paths which demonstrate best value for customers. This evidence will also involve demonstrating how the customer voice has been embedded in the proposals Scottish Water develops.

Ensuring that Scottish Water takes **accountability** for its performance during the regulatory period. This requires defining what Scottish Water is expected to deliver over the period in the form of financial forecasts and commitments and then monitoring its progress over the period. If investment priorities change over time, then EBP&R places a greater onus on Scottish Water to explain and document the changes it intends to make through the SGIG.

Ensuring that Scottish Water has sufficient **flexibility** to respond effectively to the challenges that it faces, recognising that the Scottish Government policy development work should equip the water industry with new tools to respond to these challenges and that investment priorities may change, particularly where changes in risk or additional evidence impacts the investment priorities. It will be important to ensure that the customer voice is taken into account when considering changes to investment priorities.

These principles underpin the proposed approach to the Strategic Review of Charges. They will be embedded in the proposals that follow.

QUESTIONS FOR CONSULTATION

To what extent do you agree with the key principles for SRC27 outlined above?
Are there other relevant principles that should be considered? Why?

6. Scottish Water's SRC27 submission

6.1. Overview of Chapter

This chapter provides our proposals for Scottish Water's information submission for SRC27. It covers the following areas:

- Background (section 6.2);
- Options available (section 6.3);
- Assessment of the options (section 6.4); and
- Preferred option and consultation questions (section 6.5).

6.2. Background

Economic regulators require robust information from the companies they regulate to set charge caps. This information covers the company's proposals for the forthcoming six-year period and beyond, covering several broad areas:

- financial forecasts;
- investment projects;
- levels of service performance; and
- how the company proposes to fund its operations during the regulatory period, with implications for charges and borrowing required.

It is common practice for economic regulators to ask for this information in the form of a business plan submission. In SRC21, we asked Scottish Water for a strategic plan instead. Recognising the lessons learned from SRC21 and the four principles set out in section 5.5, we are reassessing expectations and requirements for Scottish Water's submission. The submission would need to allow us to set a baseline, which represents the financial and investment delivery forecasts and commitments set out in the Final Determination. Box 6 provides the context and definition for the baseline.

Box 6: The baseline

The baseline

WICS sets charge caps based on its assessment of the lowest reasonable overall cost incurred by Scottish Water in delivering the objectives set by Scottish Ministers (through the Statement of Objectives). These charge caps must also be consistent with the Principles of Charging, which are also set by Scottish Ministers. To set these charge caps, WICS forecasts the cash (from revenue and borrowing) that Scottish Water requires to cover the efficient cost of providing water, wastewater and drainage services and delivering the investment priorities set out in Ministerial Objectives.

These forecasts therefore cover three broad categories:

- **Sources of cash:** the revenue and net new borrowing from the Scottish Government that Scottish Water will receive;
- **Uses of cash:** the expenditure in each area that Scottish Water will require to efficiently run the business and deliver the investment programme; and
- **Benefits delivered:** the commitments Scottish Water has made to customers in terms of levels of service performance and measurable deliverables from the investment programme (known as investment outputs).

Collectively, WICS refers to these forecasts and commitments as ‘the baseline’, which is usually provided before the regulatory period begins. During the period, WICS will then compare Scottish Water’s reported performance against the forecast values and commitments from the baseline and seek to understand any differences. Such monitoring allows WICS to report on whether Scottish Water has delivered the required efficiencies, the investment programme and, ultimately, to hold Scottish Water to account for delivery.

The submission needs to cover both the six-year period and beyond, recognising that the water sector is a long term and asset-intensive industry.

This chapter explores these different options and sets out our proposed approach for SRC27.

6.3. Options available

We have considered two options:

- the most recent approach of a high-level strategic plan submission as per SRC21; and
- a business plan set in the context of the long-term water sector vision.

OPTION 1: A STRATEGIC PLAN

Option 1 requires Scottish Water to provide a strategic plan. As set out in chapter 4, in SRC21 we asked Scottish Water to work with stakeholders to co-create a strategic plan. Our expectation was that the strategic plan would cover the following areas: [50]

- Scottish Water's strategic objectives;
- the investment needs and the levels of investment consistent with those objectives;
- the profile of customer charges consistent with those levels of investment;
- how Scottish Water will manage its cash over the period;
- an outline of the performance measures that will be used to assess progress;
- the steps Scottish Water is taking to build and maintain trust; and
- how Scottish Water will operate within the revised regulatory framework.

The strategic plan was based on an extensive programme of research, engagement and collaboration among stakeholders. It outlined the challenges facing the industry. However, it did not provide the supporting detail for how it could respond to these challenges. It could also have been clearer about the implications for customers' charges of the different options for responding to these challenges.[51]

The strategic plan was not intended to have the detailed evidence on future investment requirements. We, alongside industry stakeholders, expected that this would develop over time on a rolling basis through the work of the industry Investment Planning and Prioritisation Group (IPPG, now the Scottish Government Investment Group, SGIG).

OPTION 2: A BUSINESS PLAN

Option 2 requires Scottish Water to submit a business plan for the six-year period, set in the context of the long-term water sector vision. The business plan for the six-year period could set out:

- price profiles and assumed levels of borrowing;
- the allowed for level of investment;
- a forward-looking plan for investment projects and nature-based solutions;
- the outputs necessary to deliver the outcomes in the water sector vision in the six-year period; and
- levels of service measures and annual commitments for those measures.

The business plan could include data tables covering forecasts for:

- key assumptions such as population growth;
- financial projections;
- operating expenditure, operating characteristics and scope for efficiency;

[50] WICS (2018), '*Strategic Review of Charges 2021-27: Methodology refinements and clarifications*', 1 November 2018, pp.32-33.
[51] WICS (2020), '*The Strategic Review of Charges: Draft Determination*', 8 October 2020, p.50.

- investment projects and nature-based solutions; and
- levels of service commitments.

For the regulatory periods prior to SRC21, we requested a business plan from Scottish Water. Indeed, requesting a business plan supported by data tables is common practice across the regulated sectors (e.g. it is used by Ofgem for the energy transmission and distribution sector in Great Britain and Ofwat in the context of the water industry in England and Wales). For example, Ofwat requires the ten water and sewerage companies (WASCs) to populate 170 data tables grouped into 12 sections.

Ofwat also requires regulated companies to prepare a long-term delivery strategy, which includes different scenarios for future uncertainties.[52] These scenarios cover different variables such as: [53]

- the extent of climate change;
- pace of development of new technologies;
- different scenarios for growth in population and water demand; and
- different levels of ambition in relation to environmental policy.

Ofwat's guidance also requires companies to create a core pathway of low-regret investment for the regulatory period, and alternative pathways for the long term, which could be triggered depending on how these future uncertainties develop.

Table 2 provides a comparison of the two options.

[52] Ofgem follows a similar approach to Ofwat in their RIIO-3 methodology, laying out common scenarios for companies to plan pathways around. See Ofgem (2024), '*RIIO-3 Sector Specific Methodology for the Gas Distribution, Gas Transmission and Energy Transmission Sectors*', 18 July 2024.

[53] Ofwat (2021), '*PR24 and beyond: Long-term delivery strategies and common reference scenarios*', 17 November 2021.

Table 2: Comparison of the options.

Area	Option 1: a strategic plan	Option 2: a business plan
Price profiles and assumed borrowing	✓	✓
Allowed for level of investment	✓	✓
Baseline	Populated over time, during the six-year regulatory period	Forward-looking, but signalling which elements could be revisited if further information becomes available
Detail of the investment projects and nature-based solutions	The strategic plan should underpin continuity in the ongoing investment programme and include the framework for investment prioritisation. It should also include an asset improvement plan.	✓
Outline of the performance measures	✓	✓
Performance targets	×	✓ Regulatory targets

6.4. Assessment of the options

Our assessment of the options takes account of three areas:

- the expectations of Scottish Ministers set out in the Commissioning letter;
- developments to date in this regulatory period (SRC21); and
- the extent to which Scottish Water meet the proposed principles for SRC27 (see section 5.5).

Each area is examined in turn.

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

As set out in section 4.5, the Commissioning letter requests a range of charge paths for household and non-household customers covering drinking water, wastewater and drainage services. It also requests that SRC27 provides Ministers with the necessary information to understand the progress towards the Objectives and the level of risk of service failures associated with different levels of investment in the short, medium and long term.

Showing the range of charge paths based on different levels of investment and corresponding levels of risk will require Scottish Water to provide more granular information. For example, Scottish Water would need to set out the options for investment projects and nature-based solutions by each service (e.g. drainage) to allow us to understand the cost of providing those services and the corresponding impact on charges. Such information is more consistent with the information received as part of a business plan, rather than a strategic plan.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

SRC21 highlighted the importance of comprehensive forward-looking investment information prior to the Final Determination. This information is critical to establish a regulatory baseline, enabling us to hold Scottish Water accountable for its performance against this baseline.[54] To achieve this, we require disaggregated information more consistent with the information provided as part of the business plan.

THE EXTENT TO WHICH OPTIONS MEET THE PROPOSED PRINCIPLES FOR SRC27

Table 3 provides our assessment of option 1 and 2 against the principles set out in section 5.5.

Table 3: Business plan options assessment

Principle	Assessment
Evidence and analysis	The additional detail provided in a business plan means that option 2 is more suitable for allowing Scottish Water to present evidence and analysis, including through the proposed information submission alongside the plan.
Accountability	The additional detail provided through a business plan means that option 2 is more suitable in providing the information required to set a baseline, ensuring Scottish Water can be held accountable for its performance during the regulatory period.
Flexibility	Option 1 of the strategic plan provides Scottish Water with most flexibility; however, option 2 could also include mechanisms that provide Scottish Water with appropriate flexibility.

6.5. Preferred option and questions for consultation

Based on our assessment, our preferred option is to ask Scottish Water to submit a business plan set in the context of the long-term water sector vision. This would include Scottish Water submitting a draft business plan by 12 June 2025 and a final business plan by 26 February 2026, which would

[54] See our performance report for 2022-23. WICS (2024), '*Scottish Water's performance 2022-23*', 7 March 2024.

reflect the feedback received from us and other stakeholders on the draft plan (see Figure 2). Given this is the preferred option and recognising the need to ensure Scottish Water has sufficient time available to prepare a business plan, we have already started work on preparing draft business plan guidance and data tables for Scottish Water to use in preparing its business plan.

As part of a business plan, Scottish Water will need to explain what the water sector vision means in detail, covering the areas set out in section 5.2. This includes providing clarity on:

- its contribution to the sector vision;
- how its contribution to the sector vision could be measured in terms of the commitments and targets;
- the timeframe for achieving the individual elements of the sector vision;
- the options for the specific investment required to achieve its contribution to the sector vision;
- the different options for the profile of delivering the investment and nature-based solutions required to achieve the vision;
- when the full sector vision will be met; and
- how Scottish Water will measure and report on progress.

A business plan could also set out how Scottish Water will make changes to its plans during the regulatory period. As discussed in chapter 3, Scottish Water previously presented updates to its plans through the delivery plan and annual updates to the delivery plan. This ensured that there was a clear linkage between Scottish Water's most recent forecasts for financial performance, the investment programme and the requirements of the Final Determination.

We require Scottish Water to produce a delivery plan following the Final Determination. We expect that this will be based on Scottish Water's business plan but reflect any amendments made to Scottish Water's proposals through the Final Determination (e.g. to reflect our assessment for the scope for efficiency). We will also require Scottish Water to update its delivery plan each year as a way of capturing changes to the baseline from the Final Determination during the regulatory period. Such changes could include, for example, Scottish Water deciding to adopt an operational-based solution instead of a capital investment solution which was included in its proposed capital investment programme in its business plan. In this case, we would expect Scottish Water to update its baselines for operating expenditure and capital expenditure to reflect this change in approach. We discuss this further in chapters 14 and 15 on investment and levels of service respectively.

QUESTION FOR CONSULTATION

What further information could Scottish Water provide in its business plan?

7. Establishing confidence in Scottish Water's plan

7.1. Overview of chapter

This chapter provides our proposals for how Scottish Water will seek to establish confidence in its SRC27 business plan. It covers the following areas:

- Background (section 7.2);
- Options available (section 7.3);
- Assessment of the options (section 7.4); and
- Preferred options, next steps and consultation questions (section 7.5).

7.2. Background

Under EBP&R, it is important for Scottish Water to build stakeholders' confidence in its business plan and in the information supporting this plan. Assurance can play a role in helping to build such confidence.

Assurance is an important part of an organisation's corporate governance, which relates to the rules, practices and processes by which a company is directed and controlled. For example, the current UK corporate governance code places a requirement on Boards of companies following the code to provide assurance on financial and operational controls.[55] Scottish Water follows the principles and best practice contained in this code.[56] In relation to assurance, Scottish Water operates a three lines of defence assurance model, with the first line covering management controls, the second line covering risk management and the third line covering independent assurance.[57]

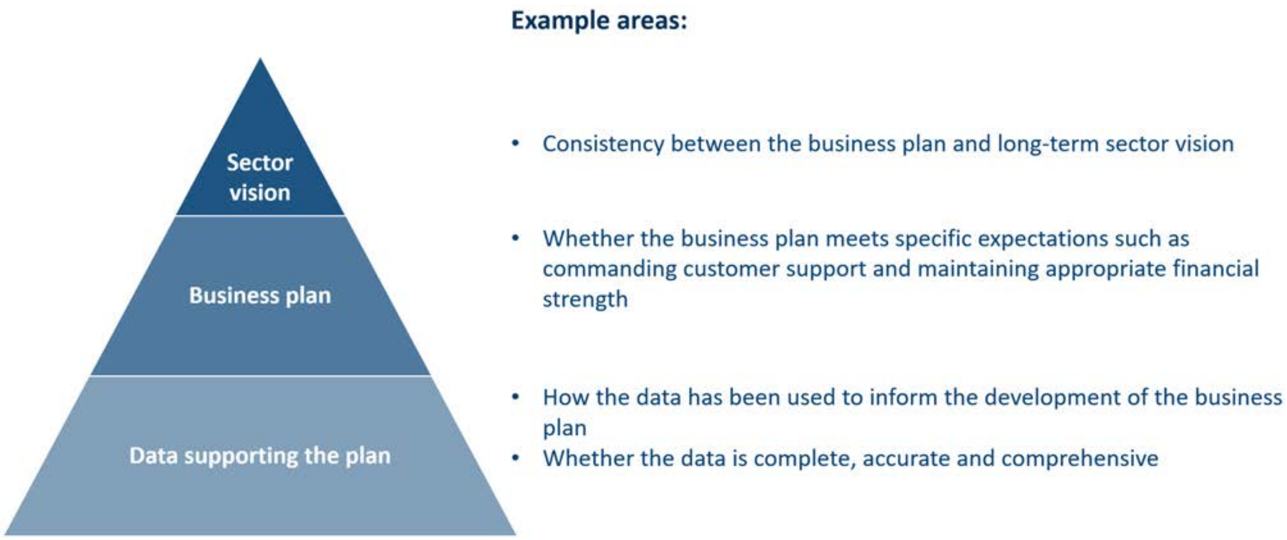
It is standard practice for economic regulators to place additional expectations on the companies over and above those set out in the UK corporate governance code, recognising that the economic regulator must have confidence in the business plan and the information contained within the plan to set charge caps. An economic regulator may also place expectations on the assurance of the information that the company provides each year through an annual information submission that the regulator uses to monitor performance against the financial forecasts and requirements from the Final Determination.

[55] Financial Reporting Council (2024), '*UK Corporate Governance Code*', 22 January 2024.
[56] Scottish Government (2023), '*Scottish Water Governance Directions 2023*', 17 July 2023, p.2, paragraph 2,.
[57] Scottish Water (2023), '*Annual Report and Accounts 2022/23: Performance and Prospects*', 31 May 2023, p.80.

In SRC21, we did not place additional expectations on Scottish Water, recognising that we wanted Scottish Water to develop the approach.[58] During the current regulatory period, we have raised questions about the quality and completeness of Scottish Water's regulatory reporting, [59] which led Scottish Water to develop a reporting quality and completeness improvement plan.[60] While we welcome Scottish Water developing a reporting quality and completeness improvement plan, we consider it prudent to reassess our approach to assurance reflecting on our experience to date in this regulatory period and recognising that Scottish Water will need to demonstrate an improvement in information quality and completeness over a sustained period. Our proposed approach to assurance must also recognise the emphasis that we are placing on analysis and evidence for SRC27.

Figure 8 recognises that there are different areas where assurance could play a role in the context of the business plan.

Figure 8: Areas of assurance in the context of the business plan



In considering the proposed approach, we need to ensure that we do not create unintended consequences, such as diluting the ownership of the Scottish Water Board over its business plan and the assurance process for that plan. We consider that ownership of the plan and the information contained in the plan remains firmly with Scottish Water.

We also need to ensure that our requirements for assurance are targeted and proportionate, and do not place an unnecessary burden and additional costs on Scottish Water relative to the expected benefits.

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[58] We instead opted to allow Scottish Water to develop a transparent internal assurance process for the evidence provided in its Strategic Plan and its Transformation Plan. WICS (2020), '*Strategic Review of Charges 2021-2027: Draft Determination*', 8 October 2020.
[59] WICS (2022), '*SRC21 Letter – Reporting quality and completeness*', 13 December 2022.
[60] Scottish Water (2023), '*Reporting Quality and Completeness Improvement Plan*', 18 April 2023.

In considering the different options, we have examined the approaches used by other economic regulators, including Ofwat (the economic regulator of the England and Wales water industry), Ofgem (the economic regulator of the energy transmission and distribution companies in Great Britain) and the Office of Rail and Road (the economic regulator of the rail network in England, Wales and Scotland).

7.3. Options available

We have considered three options:

- maintaining the current approach of not setting specific expectations for assurance;
- requesting a Board Assurance Statement and setting specific expectations for assurance in particular areas; and
- the same as option 2, but specifying the approach to be adopted in relation to the accuracy and completeness of the data underpinning the plan.

OPTION 1: OUR CURRENT APPROACH

Option 1 involves maintaining the position for SRC21 and leaving the approach to assurance to Scottish Water's Board.

An important difference between our approach in SRC21 and our proposals for SRC27 is that we will require Scottish Water to prepare a business plan supported by data tables. In this option, we would not set specific expectations on how Scottish Water provides assurance on both the business plan and the accuracy and completeness of the underlying data.

This approach aligns with the current arrangements for Scottish Water's annual information submission to us (known as the annual return). As such, the remainder of this subsection provides background on the assurance process for the annual return.

The annual return involves the following assurance processes:

- **Executive sign-off.** Each data table of the annual return is signed off on three levels: by the person who prepared the table, by the person who reviewed the submission, and by the director who authorised it. The director sign-off endorses the accuracy of the submission and holds the director accountable for that data through the Director Sign-off sheets. There is a sheet for each Director who has authorised tables to be submitted and each sheet has a list of the authorised tables.
- **Board sign-off.** We require that the annual return submissions must be signed by the Chair or by the CEO on behalf of the Board, confirming that the Board endorses the submission. Since 2007-08 this has been in the form of a Board Assurance Statement covering the full submission and signed by the CEO on behalf of Scottish Water's Board. The statement outlines at a high level the type of assurance activities which Scottish Water undertakes.

We have so far not issued specific guidance for the contents of the Director sign-off sheets and the Board Assurance Statement, nor have we defined what assurance activities are required to underpin those statements.

Scottish Water employs an independent technical assuror to review the systems and processes used to produce annual information submission and reports the findings to Scottish Water. The role of technical assuror has evolved from the Regulatory Reporter function that WICS introduced in 2003-04, based on Ofwat's requirements for the companies in England and Wales. WICS originally set the scope of the Reporter's review and the Reporter would provide assurance against this scope, reviewing the methodology and assumptions used to prepare the submissions.

As it is not formally required, it is for Scottish Water to decide whether the full technical auditor's report is included in the annual return submission, whether it is partially included or not submitted at all.

In addition, Scottish Water's annual statutory financial statements and accounts are independently audited by a company appointed by the Auditor General for Scotland in accordance with the Public Finance and Accountability (Scotland) Act 2000.[61] However, there is no formal requirement for an auditor to review Scottish Water's regulatory financial information submission, known as the regulatory accounts.

OPTION 2: REQUESTING A BOARD ASSURANCE STATEMENT AND SETTING MORE SPECIFIC EXPECTATIONS ON SCOTTISH WATER

Option 2 seeks to strengthen the current arrangements by incorporating elements of good practice from other regulated sectors, recognising the specific circumstances of Scottish Water and the principles of EBP&R. Option 2 would involve requiring a Board Assurance Statement and setting more specific expectations for Board assurance.

As set out above, Scottish Water's Board provides an Assurance Statement as part of the annual return submission. This option involves asking the Scottish Water Board to provide an assurance statement alongside the business plan and setting specific expectations for what that Statement should cover.

As a minimum, we would expect that statement to detail the specific assurance activities undertaken and the outcome of those activities. As well as requesting assurance on the overall plan, we would also ask the Scottish Water Board to set out how it has challenged and assured itself on specific aspects of the business plan. This would ensure that the assurance activities focus on the

[61] Auditor General (2022), '*Scottish Water annual audit 2021/22*', 15 November 2022.

areas that are most material to the outcome of the Strategic Review of Charges process. These could include:

- that the plan commands customer support;
- consistency with the long-term sector vision;
- that the plan represents value for money through providing challenging proposals for operating and capital expenditure efficiency and levels of service performance;
- that the plan is deliverable, considering factors such as the capacity of the supply chain in Scotland to deliver the proposed investment programme;
- that the plan maintains appropriate levels of financial strength over the 2027-33 period and beyond; and
- that the data underpinning the plan is accurate and complete and accompanying commentaries are consistent with the expectations set out in the business plan guidance.

We consider that this approach is consistent with the approach adopted by other economic regulators. For example, Ofwat required Boards to provide assurance on five broad areas in PR24 submissions: long-term delivery strategies, affordability, cost and outcomes, risk and return, and customer engagement.[62] The ORR specifically requires Network Rail to provide assurance on the deliverability of its plan (both supply-chain delivery and internal delivery), along with evidence on how the forecast costs and outcomes have been assured.[63]

OPTION 3: SAME AS OPTION 2 BUT SETTING MORE SPECIFIC EXPECTATIONS FOR EXTERNAL ASSURANCE

In addition to the proposals set out in Option 2, Option 3 requires Scottish Water to seek external assurance on the data tables and commentary underpinning the plan and other areas as appropriate. This recognises that we need to have confidence in the information and assumptions that underpin the business plan.

We could adopt a proportionate approach in Scotland that would formalise the assurance Scottish Water receives from its technical assuror on the annual information submission (known as the annual return) and extending that to the information contained in the business plan data templates and other submissions.

The formalised external assurance could review the information in the underlying business plan data templates, and other submissions, and provide a report to both WICS and industry stakeholders. We would expect the external assurance to examine whether Scottish Water had populated the data templates in line with the business plan guidance and definitions. We would also expect the review to examine the robustness of the systems and processes used to produce the information,

[62] Ofwat (2022), '*Creating tomorrow, together: Our final methodology for PR24*', 13 December 2022.
[63] Office of Rail and Road (2022), '*Periodic review 2023: Guidance to Network Rail on the preparation of its Strategic Business Plan*', 28 July 2022.

the reasonableness and materiality of any assumptions made, as well as on the accuracy, completeness and comprehensiveness of the data. We could expect them to set out:

- the areas that they identified could be strengthened throughout their review;
- what Scottish Water did in response to these comments; and
- their final conclusions.

We would expect Scottish Water to lead the assurance, but will work with Scottish Water to co-design the terms of reference and scope of the role, addressing matters such as:

- the process for recruiting and appointing the provider(s);
- the process for ensuring the provider is independent;
- how Scottish Water has investigated whether actual, potential or perceived conflicts of interest could arise and the arrangements in place to manage any such conflicts (e.g. drawing on other providers in the event of a conflict of interest);
- the scope of the external assurors review and their terms of reference;
- the timeframe over which these arrangements would be in place;
- costs associated with undertaking the assurance role; and
- how we and industry stakeholders could ask to examine a specific area from time-to-time (which industry stakeholders in the Scottish water industry have done in the past and like the ORR's powers to request that Network Rail hire an independent reporter to review matters that the ORR requires).

The proposal under this option could also involve introducing external assurance for the annual return submission in 2024-25, recognising that this would be the final full year of information available at the time when Scottish Water submits its final business plan under the proposed timeline in chapter 1.

7.4. Assessment of the options

Our assessment of the options takes account of four areas:

- the expectations of Scottish Ministers as set out in the Commissioning letter;
- developments to date in this regulatory period;
- a qualitative assessment of relative costs, as we need to be mindful that we are not imposing disproportionate costs on Scottish Water or other industry stakeholders;
- the extent to which they meet the proposed principles for SRC27 (see section 5.5).

Each area is examined in turn.

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

The Commissioning letter does not refer specifically to the quality of Scottish Water's information or assurance of that information. However, delivering the Ministerial Objectives and overall industry vision relies upon the availability of robust evidence and information.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

In considering the options, we need to recognise developments to date, particularly in this regulatory period (see section 4.4). These developments include the need to improve confidence in the quality and completeness of Scottish Water's information, specifically in relation to the reporting and evidencing of future investment needs. We consider that both option 2 which involves setting specific expectations on Scottish Water, and option 3 of placing further expectations for external assurance through a co-designed external assurance process, could help provide confidence on the accuracy and completeness of Scottish Water's information.

THE EXTENT TO WHICH THEY MEET THE PROPOSED PRINCIPLES FOR SRC27

Table 4 provides our assessment of options 1, 2 and 3 against the principles set out in section 5.5.

Table 4: Assurance options assessment

Principle	Assessment
Evidence and analysis	We consider that the proposals in options 2 and 3 could place an additional discipline on Scottish Water and enhance the quality of information submissions. This recognises that during this regulatory period we have raised questions about the completeness and comprehensiveness of Scottish Water's information, specifically in relation to the reporting and evidencing of future investment needs. Option 3 goes further by placing additional expectations for external assurance providing us and stakeholders with further confidence.
Accountability	The expectations on Board sign-off in options 2 and 3 could help enhance accountability of the Board over particular elements of the plan (e.g. as per Ofwat's approach for requiring Board assurance on financial resilience of the plan). The external assurance element of option 3 builds on this as it would verify the level of diligence Scottish Water has put into preparing its business plan.
Flexibility	Option 1 has the most flexibility. Options 2 and 3 build on the current arrangements and could be adapted over time, based on practical experience of the assurance arrangements. Scottish Water could also have flexibility to decide on other areas of assurance beyond the external review of the information contained in the business plan data templates.

7.5. Preferred option, next steps and questions for consultation

Our proposed approach is option 3, which would involve:

- the Scottish Water Board providing a Board assurance statement with specific assurance on the areas that are most material to the outcome of the Strategic Review of Charges process; and
- placing further expectations for external assurance on the data and commentaries accompanying the business plan through co-designing an external assurance process.

While we consider that Option 2 might be sufficient, we consider that Scottish Water is yet to demonstrate an improvement in information quality and completeness over a sustained period through the annual return process. As such, recognising the importance of analysis and evidence for this Strategic Review of Charges, we consider it prudent to require Scottish Water to seek external assurance on the data tables and commentary underpinning the plan and co-design the arrangements with Scottish Water. We have started to progress this work and have agreed to establish a bi-lateral assurance group with Scottish Water to develop the arrangements and monitor progress on an ongoing basis.

We will require Scottish Water to introduce the external assurance process for the annual return submission in 2024-25, recognising that this would be the final full year of information available at the time Scottish Water submits its final business plan (see the proposed timeline in chapter 1) and to test the effectiveness of the approach. We propose keeping these arrangements under review, recognising that we could revisit these expectations in the future (e.g. once there is evidence on the effectiveness of Scottish Water's assurance over a sustained period).

Our proposals for assurance reflect the minimum expectations for assurance that we would have on Scottish Water. As such, Scottish Water could undertake other areas of assurance, ensuring that it maintains ownership of the assurance process more broadly. We consider that these proposals are compatible with Scottish Water's own developing thinking of how it could take forward a risk-based approach to assurance of its business plan.

We will also put in place our own arrangements in the event we consider it appropriate to commission our own review into specific aspects of Scottish Water's proposals from time-to-time. One such area relates to reviewing the scope of Scottish Water's proposed investment solutions and costings, recognising the materiality of investment spending and that we do not have the full technical expertise internally to conduct such reviews. We cover this in more detail in chapter 14 in the context of our proposals for capital investment.

QUESTION FOR CONSULTATION

Which key elements of Scottish Water's business plan would benefit most from assurance? Why?

8. Customer engagement

8.1. Overview of Chapter

This chapter provides our proposals for customer involvement in SRC27. It covers the following areas:

- Background (section 8.2);
- Options available (section 8.3);
- Assessment of the options (section 8.4); and
- Preferred option, next steps and consultation questions (section 8.5).

8.2. Background

In the Commissioning letter for SRC27, Scottish Ministers have requested that our Final Determination commands consumers' support. This involves ensuring, together with water industry stakeholders, that consumers and local communities are placed at the heart of the SRC.

Our approach to involving customers has evolved over successive Strategic Reviews of Charges, recognising best practice in customer involvement, and Scottish Water's maturity in reflecting customers' priorities in its business plan. We are also mindful that our approach should support our 'Consumer Duty' throughout the SRC process.[64]

The challenges posed by a changing climate highlight the importance of involving customers, building greater awareness of these challenges and the possible implications for the delivery of water, wastewater and surface water drainage services. Looking forward, it will be important to work in partnership with customers, communities and other agencies to develop solutions that enhance the industry's ability to respond to these challenges and ensure that services remain resilient in the face of a changing climate. The Scottish Government's policy development work is considering ways to enable such partnerships (e.g. in relation to the deployment of blue-green infrastructure such as rain gardens). This will require Scottish Water and industry stakeholders to take customer involvement to the next level.

It is important to recognise that Scottish Water serves different types of customers, each with their own specific needs and priorities. These are:

- household customers;
- licenced providers;
- non-household end-users; and

[64] UK Parliament (2024), *'The Consumer Scotland Act 2020 (Relevant Public Authorities) Regulations 2024'*, 9 January 2024.

- developers.

It also serves different types of communities, covering:

- communities of interest: groups sharing a common interest, but not necessarily bound by a common geographical area; and
- communities of place: groups of people bound by living and/or working in the same place or geographical area.

It is important that Scottish Water understands the needs and priorities of these different types of customers and communities.

Scottish Water's current arrangements for customer involvement are set out in Figure 9. These include several initiatives, highlighted in the boxes with the dashed line.

Figure 9: Customer involvement framework in Scotland

These arrangements include:

- **An operationally independent customer group.** Scottish Water hosts an 'independent customer group' (ICG) with a remit to provide strategic challenge and support to Scottish Water on the following areas:
  - enhancing and embedding its focus on customers and communities;
  - embracing its commitments to delivering wider public benefit and enhancing the natural environment;
  - implementing investment decision-making processes which reflect customer and community expectations;
  - maintaining and enhancing customer service as Scottish Water transforms to deal with the impact of global warming and going beyond net zero emissions; and
  - adopting a more prominent profile as a confident, responsible and ambitious publicly owned company, leading, forming partnerships and driving change.
- Scottish Water has also given the ICG a remit to develop an evidence base by co-ordinating and collaborating on customer research with sector stakeholders and agreeing the interpretation of results. The group publishes a report each year and provides comment on Scottish Water's annual charges scheme. Scottish Water summarises the role of the ICG as 'in all it does the ICG will support and encourage Scottish Water to meet its commitment to take every decision as if the customer were in the room'.[65]
- **An annual consultative meeting.** Scottish Water holds an annual consultative meeting to update customers and stakeholders on its performance over the previous year and highlight future plans. These sessions are open to all customers and stakeholders and are broadcast online.
- **Community involvement.** Scottish Water also involves customers on a more localised basis when it comes to delivering investment in local areas. We are pleased that Scottish Water has made good progress in this area in recent years.[66]
- **Customer research initiatives and intelligence from data.** Scottish Water conducts its own research and uses the intelligence that it gains from data (e.g. customer contacts, social media contacts) to understand customer and community priorities.

In the context of customer involvement in the Strategic Review of Charges, we assess the different options for customer involvement with the principles for SRC27 set out in chapter 5. In particular, the approach to customer involvement should:

- ensure that Scottish Water has appropriate **ownership** and **accountability** over the process, while meeting the expectations of its stakeholders;

[65] Further information on the ICG is available at https://www.scottishwater.co.uk/About-Us/What-We-Do/Independent-Customer-Group.

[66] Scottish Water has also undertaken work to understand best practice through commissioning a study with Citizens Advice Scotland and the Customer Forum on community engagement best practice. Ipsos Mori (2019), '*Research into community engagement best practice*', July 2019. Good examples relate to engaging with local communities in Strathpeffer in relation to sewer renewals. Scottish Water (2019), '*Delivery Plan Update 2019*', March 2019, p.7.

- provide **high-quality** information *and* evidence on customer priorities; and
- be **adaptable**, recognising that there are different elements to customer involvement and that customer involvement should be an ongoing and enduring aspect of Scottish Water's activities. We do not want to limit Scottish Water's ability to adapt its approach to suit any changes to its circumstances.

8.3. Options available

We have reviewed the different customer engagement models adopted by other economic regulators in UK and internationally.

These options are not necessarily mutually exclusive, and it may be that there are combinations of different options that will provide most confidence that the business plan reflects the needs and priorities of customers and communities.

OPTION 1: CUSTOMER CHALLENGE GROUP

The first and most prevalent model used in other sectors is the Consumer Challenge Group (CCG) model, which has been used in the water industry in England and Wales (Ofwat), energy transmission and distribution networks (Ofgem), and airport regulation (CAA in the case of Heathrow airport). Appendix 8 provides case studies of models of CCGs.

The model involves the company establishing a CCG to provide independent challenge on its customer engagement activities. The CCG then provides assurance to the regulator on:

- the quality of a company's customer engagement; and
- the extent to which the results of the engagement are driving the company's business plan.

The CCG provides its assurance in an independent report to the regulator that is submitted alongside the company's business plan. The role of the CCG is more focused than a Customer Forum model. It is also not the role of CCGs:

- to provide assurance that all costs included in the company's plan are efficient;
- to act as a substitute for a company engaging its actual customers; and
- to substitute its views for those of customers.

The economic regulator requires the company to demonstrate that its relationship with the CCG is at arm's length, to ensure that it can provide independent challenge and assurance to the regulator. This involves asking the company to set out the governance arrangements for the CCG, covering:

- the recruitment process;
- any remuneration arrangements;
- any conflicts of interest;
- support and resources provided to the group;

- the expertise of the members; and
- the process that will be followed to involve them.

In the context of the industry in England and Wales, for its recent price review Ofwat has recognised the progress companies have made in orientating their decision making and business plans towards the needs and views of customers. As such, Ofwat decided against prescribing a standardised approach of a CCG. Instead, Ofwat set higher-level expectations for each company to put in place challenge and assurance solutions for customer engagement that meet its specific needs and ambitions.[67] Some companies have continued to have a CCG providing assurance on the quality of engagement and the extent to which the results of the engagement are reflected in the company's business plan.

OPTION 2: NEGOTIATED SETTLEMENT

The concept of negotiated settlement was made popular by Stephen Littlechild[68] after observing some engagement practices in some regulated sectors in North America. The key aim was to move away from the traditional regulatory model to one where regulated companies are incentivised to understand and reflect customers' views in their plans (rather than solely focusing on regulators' expectations).

In Scotland WICS introduced a negotiated settlement model by establishing a Customer Forum for SRC15. The model is built on the fact that there are two distinct inputs into the SRC process:

- ensuring that customer and community views are embedded in the Scottish Government's policy for the water industry, as set out in the Ministerial Objectives and the Principles of Charging of the Scottish Ministers; and
- ensuring that Scottish Water's business plan reflects customer and community priorities *within* this overall policy framework of the Scottish Ministers, recognising that there remain choices over what improvements are delivered, when they are delivered and at what cost.

The first area was the responsibility of the consumer advocacy body in the Scottish water industry, previously Consumer Focus Scotland but now Consumer Scotland. The second area was the responsibility of a Customer Forum, established through a tri-partite agreement between WICS, Scottish Water and the Consumer Futures Unit of Citizens Advice Scotland (the consumer advocacy body at the time). The Customer Forum had a specific remit to act as a conduit for customers' views and seek to reach agreement with Scottish Water on the business plan for SRC15.[69, 70]

[67] Ofwat (2021), *'PR24 and beyond: creating tomorrow, together'*, 27 May 2021, p.64.
[68] Littlechild, S., Doucet, J (2006), *'Negotiated settlements: The development of economic and legal thinking'*, 2006.
[69] WICS (2013), '*Strategic Review of Charges 2015-21: Innovation and choice*', 1 May 2013.
[70] Littlechild, S. (2014), *'The Customer Forum: customer engagement in the Scottish water sector'*, July 2014.

The approach was built upon for SRC21, eventually evolving into a co-creation process involving Scottish Water, the Customer Forum and industry stakeholders working in partnership to co-create a strategic plan.

OPTION 3: DELIBERATIVE RESEARCH

Deliberative groups are one of the techniques that can be used to seek views about a particular topic. In deliberative research, a sample of citizens form a group tasked with learning about the topic, considering the relevant evidence and discussing with other participants, before coming to a view.[71] This is typically used for longitudinal research on a key strategic issue underpinning the business plan.

Deliberative research could take the form of workshops, or, on a larger scale, citizens' assemblies, typically involving around 50-200 participants, who are selected to be broadly reflective of the general public.[72] A citizens' assembly typically involves:[73]

- a learning phase;
- a consultation phase, whereby external experts or advocates can present their arguments and be questioned on them by the members of the assembly; and
- a deliberation and discussion phase, generally ending in assembly members making recommendations.

Deliberative research has recently been used by Consumer Scotland, to understand customer views relating to the climate change adaptation challenges faced by the water sector in Scotland.[74] It has also been used by regulated companies to engage consumers on strategic topics in Australia[75] and New Zealand[76]. More broadly, the emphasis on learning and making an informed decision means that deliberative research can be effective in engaging the public on more complex issues. By creating a dialogue with participants, it may also provide scope to develop into longitudinal research over a longer timeframe. Longitudinal research would involve collecting information from the same individuals over a period of time, providing an understanding of how customer views or perceptions change.[77]

8.4. Assessment of the options

Our preferred option involves a combination of option 1 and option 3.

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[71] Scottish Government (2009), *'Scottish Government Social Research Group: Social Science Methods Series: Guide 1: Deliberative Methods'*, 9 December 2009.
[72] Scottish Parliament (2022), *'Citizens' Assemblies – an international comparison'*, 01 February 2022.
[73] Electoral Reform Society (2019), *'What Are Citizens' Assemblies?'*, 28 June 2019.
[74] The findings of this research are yet to be published at the time of writing.
[75] Participedia, *'Yarra Valley Water Citizens' Jury'*, webpage.
[76] Te Kawa Mataaho (2023), *'Deliberative processes – citizens' juries and citizens'* assemblies', webpage.
[77] Scottish Government (2009), *'Scottish Government Social Research Group: Social Science Methods Series: Guide 8: Longitudinal research'*, 9 December 2009.

Our assessment of the options takes account of three areas:

- the expectations of Scottish Ministers as set out in the Commissioning letter;
- developments to date in this regulatory period; and
- the extent to which they meet the proposed principles for SRC27 (see section 5.5).

Each area is examined in turn.

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

The Commissioning letter sets a clear expectation on WICS to ensure that the Final Determination commands consumers' support and that, together with water industry stakeholders, consumers, communities and the environment are placed at the heart of this SRC.

Option 1 and 3 would ensure that the final plan is underpinned by consumers' support and by robust and unbiased customer research.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

We recognise that SRC21 advanced discussions on the long-term challenges and the development of the sector vision. Therefore, it is not necessary to repeat the same process involving the Customer Forum and co-creation. The approach to customer engagement should reflect the maturity of the different industry stakeholders involved in the SRC process, especially considering the commitment and resource requirement by stakeholders towards a negotiated settlement process.

We are also mindful of the lessons learnt from SRC21 and that establishing a group tasked with negotiating a business plan with Scottish Water would require a significant time and financial resource. It can also present some risks in reducing legitimacy if the representative group is not perceived as acting as a conduit of customers views. It also has the potential to reduce ownership of Scottish Water on its plans. This suggests that it might not be appropriate to repeat a negotiated settlement process for SRC27.

We expect instead Scottish Water to work alongside Consumer Scotland and ourselves to build on the existing ICG model to ensure that the challenge function is carried out robustly, effectively and independently. The contribution of the challenge group should be appropriately documented as part of the submission. We expect that this will include Scottish Water producing a clear log of how the challenge has impacted the development of the business plan (e.g. the changes that Scottish Water has made). Depending on the final arrangements and the terms of reference of the challenge group, this may also involve the challenge group producing their own report alongside Scottish Water's business plan.

THE EXTENT TO WHICH THE OPTIONS MEET THE PROPOSED PRINCIPLES FOR SRC27

Table 5 provides our assessment of the options against the principles set out in section 5.5.

Table 5: Customer engagement options assessment

Principle	Assessment
Evidence and analysis	Options 1 and 3 meet the expectations for high-quality information and evidence on customer priorities by requiring Scottish Water's plans to be based on sound customer research. A CCG would help ensure that the research is conducted robustly and in line with best practice and that it is appropriately reflected in Scottish Water's plans.
Ownership and accountability	Options 1 and 3 would provide Scottish Water with most ownership over the customer involvement process, given that it would be responsible for establishing these arrangements and WICS would have limited involvement in the process. The proposed approach would require Scottish Water to explain in advance how its plans are underpinned by customers' support.
Flexibility	All options are sufficiently flexible.

8.5. Preferred option, next steps and questions for consultation

We consider that a combination of option 1 and option 3 would best meet our principles of ownership and accountability on Scottish Water and support high-quality information and evidence of customer priorities.

Consistent with the principles of EBR, our proposed approach involves setting out clear expectations on Scottish Water to work openly and collaboratively with both Consumer Scotland and WICS on the:

1. Design and development of customer research through a multi-stakeholder coordination group. This will include undertaking a longitudinal, deliberative research to understand strategic prioritisation and customers' acceptability of the business plan.
2. Establishment of a Customer Challenge Group that would provide assurance on:
    a. the quality of Scottish Water's customer engagement and research; and
    b. the extent to which the results from the engagement/research have been reflected in Scottish Water's business plan.

We believe this approach would allow the industry to build on the customer engagement experience from previous SRCs whilst ensuring that customer research is conducted robustly and that customers views are embedded in Scottish Water's plans.

We want to ensure that customer research carried out by different stakeholders is complementary and constructively explores customer preferences. We also want to ensure that the engagement process focuses on matters that are within WICS' remit and does not seek to influence or undermine the Principles of Charging set out by Scottish Government as part of SRC27.

In line with the principles of EBR, we therefore plan to put in place a tri-partite agreement with Scottish Water and Consumer Scotland setting out the principles and programme of joint work on customer engagement. These would involve:

- **Legitimacy**: Customer research is well designed, comprehensive, robust, unbiased, independent and follows best practice. Scottish Water's business plan reflects visibly and credibly customer views including explaining how those views have been has incorporated in the business plan.
- **Empowerment**: Customers and communities will be empowered by setting a clear expectation on Scottish Water to take ownership of its business plan and charges and demonstrate that both command customer support.
- **Challenge**: Scottish Water will be challenged robustly to demonstrate that plans are reflective of customer expectations through an independent group.
- **Collaboration**: Effective coordination and co-design of customer research building on the principles of Evidence Based Research.

The agreement will also set out the workplan, activities and different roles and responsibilities of stakeholders throughout the SRC in relation to the customer research activities. It will also specify what arrangements Scottish Water will put in place to ensure that the independent challenge function is robust and independent.

Discussions on the tripartite agreement have already begun and we expect the agreement to be finalised for our final methodology.

QUESTION FOR CONSULTATION

Do you support our proposed approach on customer engagement? Why?

9. Core and non-core activities

9.1. Overview of chapter

This chapter provides our proposals for how we could define the activities subject to economic regulation. It covers the following areas:

- Background (section 9.2);
- Proposed approach (section 9.3); and
- Assessment of the proposed approach (section 9.4).

9.2. Background

To set charge caps consistent with the lowest reasonable overall cost of delivering the objectives of Scottish Ministers, we need to understand the nature and efficient level of Scottish Water's costs. This covers aspects such as:

- how costs are spread over Scottish Water's different activities, recognising that Scottish Water's main role is to provide water and wastewater services, but that it also undertakes other ('non-core') activities. The scope of our charge caps relate to Scottish Water's core activities.
- the balance of costs borne by current and future customers.
- the breakdown of Scottish Water's costs, to understand the scope for efficiency in each area of costs.

There are other aspects of costs that we do not cover as part of this methodology. This includes understanding the costs of serving different customers, which are important to understand whether cross-subsidies exist between different customers. In this context, cross-subsidy arises when the revenue arising from a customer does not reflect the cost of serving that customer. The Scottish Government's Principles of Charging cover matters such as cross-subsidisation between customers – some of which is desired (e.g. geographical harmonisation of charges for customers in the same category across Scotland)[78] and some of which is not desired (e.g. cross-subsidisation between household and non-household customers).[79] These are matters of government policy which we help to inform by:

- identifying areas where Scottish Water may need to take action in the future to remove cross-subsidies that are not permitted under the Principles of Charging; and/or

[78] Principle 3 of the Draft Principles of Charging relate to harmonised charges. Principle 3 sets out 'Ministers require that charges should, for similar services provided to customers of a similar category, be the same for each customer in that category regardless of their location in Scotland.

[79] Principle 4 of the Draft Principles of Charging relate to cost-reflective charges. Principle 4 sets out 'Charges should remain broadly cost-reflective. In particular, charges for given services (for example drinking water) to particular customer groups (for example households) should be set to recover the cost to Scottish Water nationally of providing that service to that group as a whole'.

- informing the Scottish Government's future policy on such matters where requested.

This chapter focuses on how costs are spread over Scottish Water's different activities.

Scottish Water exists to provide water and sewerage services to customers in Scotland.[80] The activities involved in performing this role constitute its 'core' activities. However, Scottish Water can also engage in other activities provided these are not inconsistent with the economic, efficient and effective exercise of its core functions.[81] These activities are known collectively as 'non-core' activities.

Current legislation provides the definition of core and non-core activities.[82] We use regulatory accounts to document the activities that belong in each category based on the legislation in place and how the revenues and costs should be accounted for.[83] The regulatory accounts also provide rules to underpin the interactions between core and non-core activities. The last comprehensive review of Scottish Water's core and non-core activities was undertaken in 2006.[84]

Since 2006, Scottish Water's non-core activities have grown significantly primarily due to the expansion into the non-household retail market in England by Business Stream – Scottish Water's non-household retail subsidiary. There have also been further developments such as:
- investments in renewable energy via Scottish Water's non-core subsidiary, Scottish Water Horizons. These investments are part of Scottish Water's commitment to reduce operational emissions by at least 75% by 2030 (see chapter 4);[85] and
- Scottish Water taking over wastewater treatment assets previously managed through Private Finance Initiative (PFI) contracts (known as PFI repatriation), before transferring these assets back into the core business.

Since Scottish Water's non-core activities are different today than they were in 2006, we believe that the regulatory accounts need to be updated to document which specific activities are core or non-core and the revenues and costs that belong in each category. We also consider that establishing principles for documenting activities as core or non-core will provide more clarity for how any new activities should be accounted for in the future.

[80] Section 70 of the '*Water Industry (Scotland) Act 2002'* (the 2002 Act) covers the functions of Scottish Water.
[81] Section 25 of the 2002 Act.
[82] This relates to Section 70 of the 2002 Act, which itself refers to the '*Sewerage (Scotland) Act 1968*' and the '*Water (Scotland) Act 1980'*.
[83] The regulatory accounting rules also set out the rules that Scottish Water should follow to allocate any shared costs between core and non-core activities and report on any financial transactions between Scottish Water's core and non-core business.
[84] WICS (2006), '*2005-06 regulatory accounts*'. The activities defined as core and non-core are set out in Regulatory Accounting Rule 4. WICS (2006), '*2005-06 accounting rules 4*'.
[85] Scottish Water (2020), *'Net Zero Emissions Routemap'*, 13 September 2020, p.10.

The remainder of this section provides further information on why it is important to have clarity on core and non-core activities and provides an overview of the current situation and relevant considerations.

WHY IT IS IMPORTANT TO HAVE A CLEAR DEFINITION BETWEEN CORE AND NON-CORE ACTIVITIES

Clearly defining core and non-core activities helps to:

- protect customers of the core business, ensuring that their charges reflect the lowest reasonable overall cost of Scottish Water delivering the Objectives of the Scottish Ministers; and
- ensure that Scottish Water does not gain an unfair advantage over other providers if it engages in activities unrelated to providing water and wastewater services, which are subject to competition. If there is a lack of clarity and separation between core and non-core activities, then a regulated company may face a higher risk of challenge under competition law.

We cover each point in turn below.

Protecting customers

Our role is to protect customers of the core business through ensuring that their charges reflect the lowest reasonable overall cost of delivering the Objectives of the Scottish Ministers. In assessing the lowest reasonable overall cost, we need clarity over the activities that are subject to our charge cap.

We also need to ensure that the revenue generated through charge caps are used only for delivering Ministerial Objectives. In this context, cross-subsidy refers to any monetary aid or contributions to a non-core activity which is not merited by the receipt of:

- services received from the non-core activity; or
- the full reimbursement of costs incurred associated with the non-core activity using assets or a resource of the core business.

A cross subsidy from core to non-core activities can arise in different ways. For example, a cross-subsidy could arise if non-core activities use core assets but do not pay a fair contribution towards the cost of using those assets.

Other cross-subsidies may not be as obvious. For example, one key reason for maintaining clarity and separation between core activities and other company activities, is to prevent management from spending a disproportionate amount of time on non-core activities rather than focusing on the provision of water and wastewater services. Such a situation could impose additional indirect costs on the customers of the core business.

Irrespective of how a cross-subsidy arises, the impact is the same: customer charges are higher and/or service is worse than it otherwise would be.

Ensuring that a company is not gaining an unfair advantage over other providers in a competitive market

If there is a competitive market for those non-core activities, then there is a risk that a company could be perceived as gaining an unfair advantage by using its position providing core activities (where it is not subject to competition) to cross subsidise its non-core activities (where competition exists).

In addition to ensuring clarity between core and non-core activities, it may also be appropriate to implement some form of separation to demonstrate that these activities are conducted at arm's length from each other. There are different forms of separation, ranging from accounting separation to legal separation, which involve activities being held in different legal entities with their own Board and governance arrangements.[86] For example, the legal separation between Scottish Water and its non-core subsidiary Business Stream, which purchases wholesale services from Scottish Water and competes against other licenced providers in the non-household retail market, was implemented to demonstrate that Scottish Water's wholesale activities are undertaken at arm's length from Business Stream's retail activities.

Ultimately, clarity and separation between core and non-core activities help to reduce the risk of a company being perceived as gaining an unfair advantage, which may materialise in the form of:

- a challenge under competition law;[87] or
- a challenge under subsidy control legislation (previously state aid), recognising Scottish Water's public ownership.[88]

Either scenario could expose customers of the core activities to additional risk and cost. For example, indirect costs such as management time and focus and direct costs such as legal fees and monetary compensation if a court found in favour of a claimant.

[86] Cave M. (2006), '*Six Degrees of Separation Operational Separation as a Remedy in European Telecommunications Regulation'*, Communications and strategies, No.64, p.89, 4th quarter 2006.
[87] UK Parliament (1998), '*Competition Act 1998*'.
[88] The UK subsidy control regime replaced the previous EU state aid regime. It aims to prevent public authorities from giving financial advantages to enterprises in a way that could create excessive distortions of competition. Department for Business and Trade (2023), '*Statutory Guidance for the United Kingdom Subsidy Control Regime: Subsidy Control Act 2022'*, December 2023.

CURRENT SITUATION AND RELEVANT CONSIDERATIONS

The original documentation of core and non-core activities in the 2006 regulatory accounting rules, as reproduced in Appendix 4, no longer reflects the current situation.

The theory and practice regarding the definition of core and non-core activities has also developed further since 2006, recognising that regulated companies are engaging in other related activities. Therefore, we need to embed this latest thinking in our approach.

Our starting point is the definition of Scottish Water's core functions in legislation. In most cases, Scottish Water's core functions and the activities associated with fulfilling these functions are obvious. However, there are some examples that are less obvious. An area that merits further consideration relates to cases where the assets of the core business are used to provide other non-core activities.

An example relates to a water company's water sampling activities. Some companies (including Scottish Water) provide sampling and testing services to third parties alongside its own water quality sampling activities. In this case, the water companies are utilising the expertise and (most likely) the excess capacity it has available in providing water services.

Another example relates to renewables, where a number of considerations could be relevant:

- whether the output or the main function of the renewable energy activity relates to the provision of water and wastewater services. One such example could be a renewable energy asset (e.g. solar panels or turbine) that is used to generate electricity to power a treatment works or a collection of works; and
- whether the renewable energy is a direct product of providing water and wastewater services. For example, the energy produced from the treatment of biosolids (previously known as sludge), which is a byproduct of the wastewater treatment process that can be used to produce renewable forms of energy such as biogas.

In these examples, it may be viewed that the water company is acting commercially within the provision of existing services. We distinguish these activities from other activities involving an investment in related markets to generate a return, which may expose customers to a disproportionate level of risk.

The key question is who should benefit from the revenues generated by a water company's commercial activities and where should the associated costs and risks sit. Some economic regulators consider that customers should receive the full benefit of the revenue generated by commercial activities. For example, the Civil Aviation Authority uses a 'single till' approach, where revenue from commercial activities such as retail and parking is used to offset the regulated airport charges by paid by airlines. This approach is equivalent to treating all activities as core for the purposes of regulation[89], partly because separating commercial and aeronautical assets at airports is challenging.

Other economic regulators such as Ofwat adopt a similar approach but only for certain commercial activities that utilise assets customers have paid for as part of the company's core activities and have underwritten the risks associated with providing those core activities. As such, if a company can earn additional revenue by realising commercial value from those assets, then the company should share the additional income with customers who paid for the asset and continue to underwrite the risks associated with it.[90] An example relates to income related to the sale of biosolids, or bio-methane gas which can be produced from biosolids, which Ofwat offsets against the revenue the company is able to collect from customers in relation to bioresources.[91]

Our proposed approach is set out below.

9.3. Proposed approach

The revenues associated with non-core activities is worth around £490m (removing inter-company eliminations) in 2023-24, of which around £470m or 95% relates to Business Stream in outturn prices.[92] The remaining £20m or 5% relates to other non-core activities. Recognising the scope of Scottish Water's activities may increase in future (e.g. given the Scottish Government's policy development work, which covers areas such as partnership approaches and resource recovery that may result in new income streams)[93], we consider that it is important to document which activities are core and non-core and provide clarity on the revenues, costs and the level of risk in each category. We also propose establishing principles for documenting new activities in the future.

As such, we consider that the only feasible option available is to update the current regulatory accounts, to document which activities are core and non-core and provide clarity on the revenues, costs and level of risk in each category. We have commenced work with Scottish Water to update the regulatory accounts, to reflect the current situation and the latest thinking in this area. This involves working with Scottish Water to develop a series of questions to help categorise activities

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[89] Civil Aviation Authority (2022), '*Economic regulation of Heathrow Airport: H7 Final Proposals – Summary*', June, p.4.
[90] A more comprehensive discussion is provided in Ofwat (2010), '*The Treatment of regulated and unregulated business in setting price controls for monopoly water and sewerage services in England and Wales – a discussion paper*', October 2022.
[91] See page 19 of Ofwat's most recent regulatory accounting guideline 4 (RAG 4.12). Ofwat (2024), '*RAG 4.12 – Guideline for the table definitions in the annual performance report*'. This shows that the income received from sales which are external to the appointed business, covering areas such as bio-methane gas sales to the national grid and sludge and sludge products such as cake, granules etc. to external parties that is then netted from operating expenditure, which is a key building block to assess required revenues.
[92] Scottish Water provided information on its revenues for financial year 2023-24, of which: £1,479m related to Scottish Water's core activities; £676m related to Business Stream (with £206m relating to inter-company transactions) and £19m relating to other activities.
[93] Scottish Government (2023), *'Water, wastewater and drainage policy: consultation'*, 21 November 2023, p.20.

as core or non-core and determine the appropriate allocation of revenues and costs. We propose to apply these principles to all activities except those involving its subsidiary Business Stream, which must be kept at arm's length from Scottish Water for level playing field considerations and is demonstrably non-core. The list below shows the initial questions that we could use to update the regulatory accounts based on the discussion in this chapter.

- The activity relates to the provision of water and sewerage services as per Section 70 of the 2002 Act or other relevant legislation in place
    a. If yes: the associated revenues and costs should be allocated to core
- The output of the activity is used in the provision of water and wastewater services in Scotland as defined in legislation
    b. If yes: the associated revenues and costs should be allocated to core
- The activity involves extracting commercial value from assets used to provide water and wastewater services at limited risk to customers
    c. If yes: the associated revenues and costs should be allocated to core
    d. If no: non-core

We consider that it is for Scottish Water to manage and demonstrate compliance with competition law and subsidy control, particularly for activities where it competes in the market (such as sampling for third parties) alongside its core activities.

We propose using the same set of questions to agree whether new activities undertaken by Scottish Water in the future should be documented as core or non-core in the regulatory accounts. We consider that this approach ensures there is a common understanding about how new activities should be considered.

During the regulatory period, we consider that there should be a role for explicit annual assurance on the extent to which Scottish Water is following the cost allocation and transfer pricing rules set out in the regulatory accounting rules. We also propose undertaking more comprehensive reviews of internal transactions (or transfer prices) between core and non-core activities at set intervals (e.g. every 2-3 years). Such reviews were undertaken in the past, around the time of the opening of the non-household retail market in April 2008.[94]

9.4. Assessment of the proposed approach

Our assessment of the proposed approach takes account of three areas:

- the expectations of Scottish Ministers set out in the commissioning letter;

[94] Arup et al. (2009), *'Transfer pricing in the Scottish water industry: Scottish Water's compliance with Regulatory Accounting Rule 5'*.

- developments to date in this regulatory period (SRC21); and
- the extent to which Scottish Water meet the proposed principles for SRC27 (see section 5.5).

Each area is examined in turn.

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

The definition of core functions is set out in legislation. The Commissioning letter does not provide further expectations in terms of the definition of core and non-core activities.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

We have asked questions about whether Scottish Water's reported revenues and costs for the core business are consistent with the assumptions made in the Final Determination. The proposed option will ensure that there is clarity.

THE EXTENT TO WHICH THE PROPOSED APPROACH MEETS THE PROPOSED PRINCIPLES FOR SRC27

Table 6 provides our assessment of the proposed approach against the principles set out in section 5.5.

Table 6: Core and non-core option assessment

Principle	Assessment
Evidence and analysis	The updated regulatory accounts will provide clarity that the definition of core and non-core activities and associated expenditures are consistent over time (see also chapter 13 on operating expenditure).
Accountability	The updated regulatory accounts will provide clarity, enhancing the accountability of Scottish Water.
Flexibility	The proposed option provides flexibility for dealing with new activities that Scottish Water undertakes, allowing updates to the regulatory accounts to be made more easily.

QUESTION FOR CONSULTATION

Do you have any views on our proposals to provide further clarity on the definition of core and non-core activities for the purpose of our regulation?

10. Balancing costs between current and future customers

10.1. Overview of Chapter

This chapter provides our proposals in relation to the balance between current and future customers. It covers the following areas:

- Background (section 10.2);
- Proposed approach (section 10.3); and
- Assessment of the proposed approach (section 10.4).

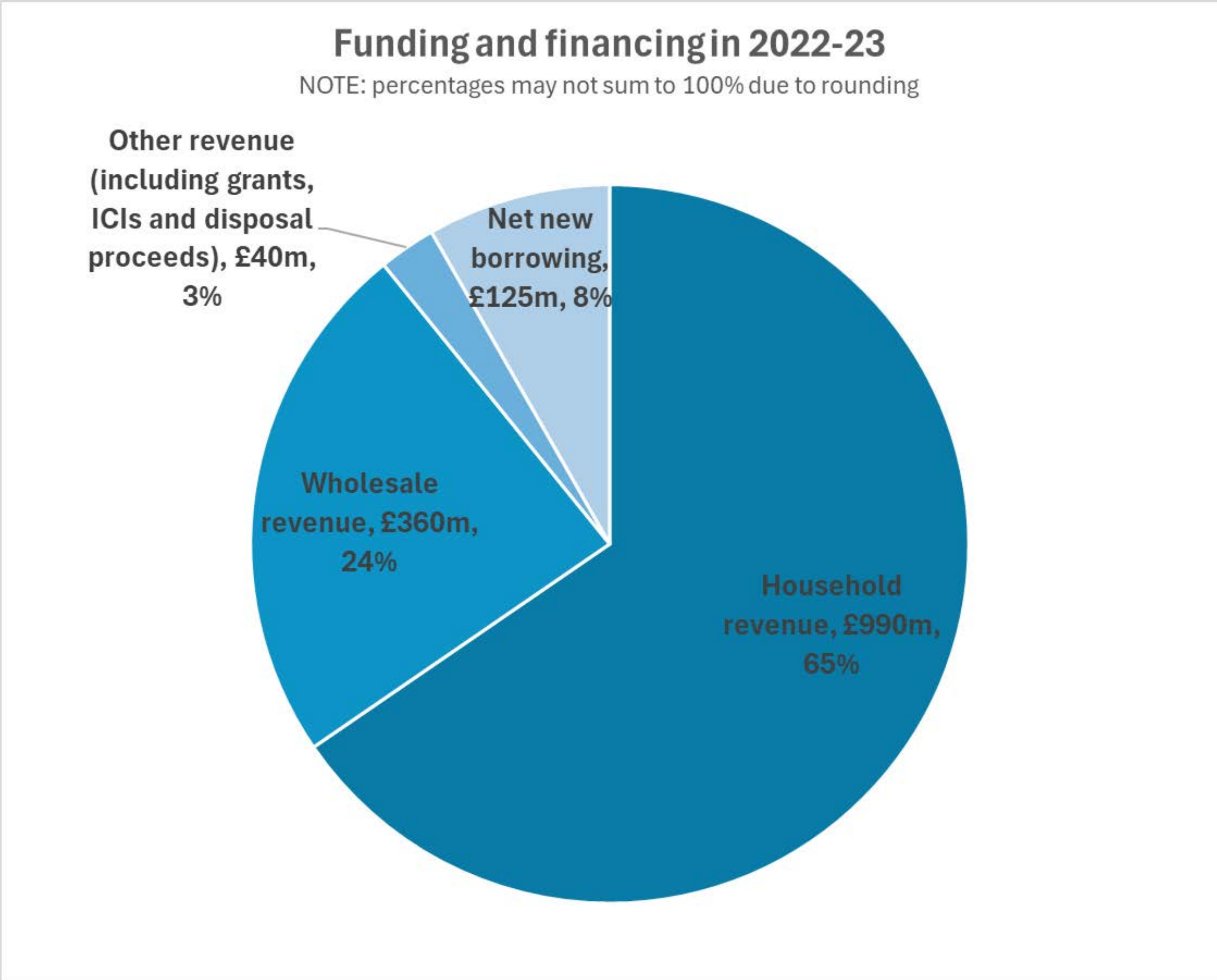
10.2. Background

SETTING CHARGES

Sources of funds and financing

Most of Scottish Water's cash inflows come from customer charges and borrowing, with a small additional inflow from other sources such as grants, contributions and infrastructure charges from developers as shown in Figure 10. Any outperformance achieved by Scottish Water is reinvested in the business.

Figure 10: Funding and financing in 2022-23.



The maximum amount of borrowing available to Scottish Water is set by Scottish Ministers in their Principles of Charging for the industry. To pay for investment, Scottish Water is free to borrow within the public sector allowance that has been granted in the Scottish Government's Budget. Scottish Water and Scottish Government agree the timing of this borrowing within the financial year and the duration of the borrowing. Each year, Scottish Water pays interest on this borrowing, and on maturity of the loan it repays the principal, currently through refinancing the debt. As such, Scottish Water effectively rolls-over maturing debt at prevailing interest rates and we refer to the new borrowing in the year less the borrowing repaid in the year as net new borrowing (as discussed above).

Scottish Water must comply with the rules of public expenditure. While it can borrow from any source, it must be able to demonstrate that it is accessing the cheapest source available. This has the effect of ensuring that all medium and longer term borrowing is provided by the Scottish government.

Applications of funds and financing

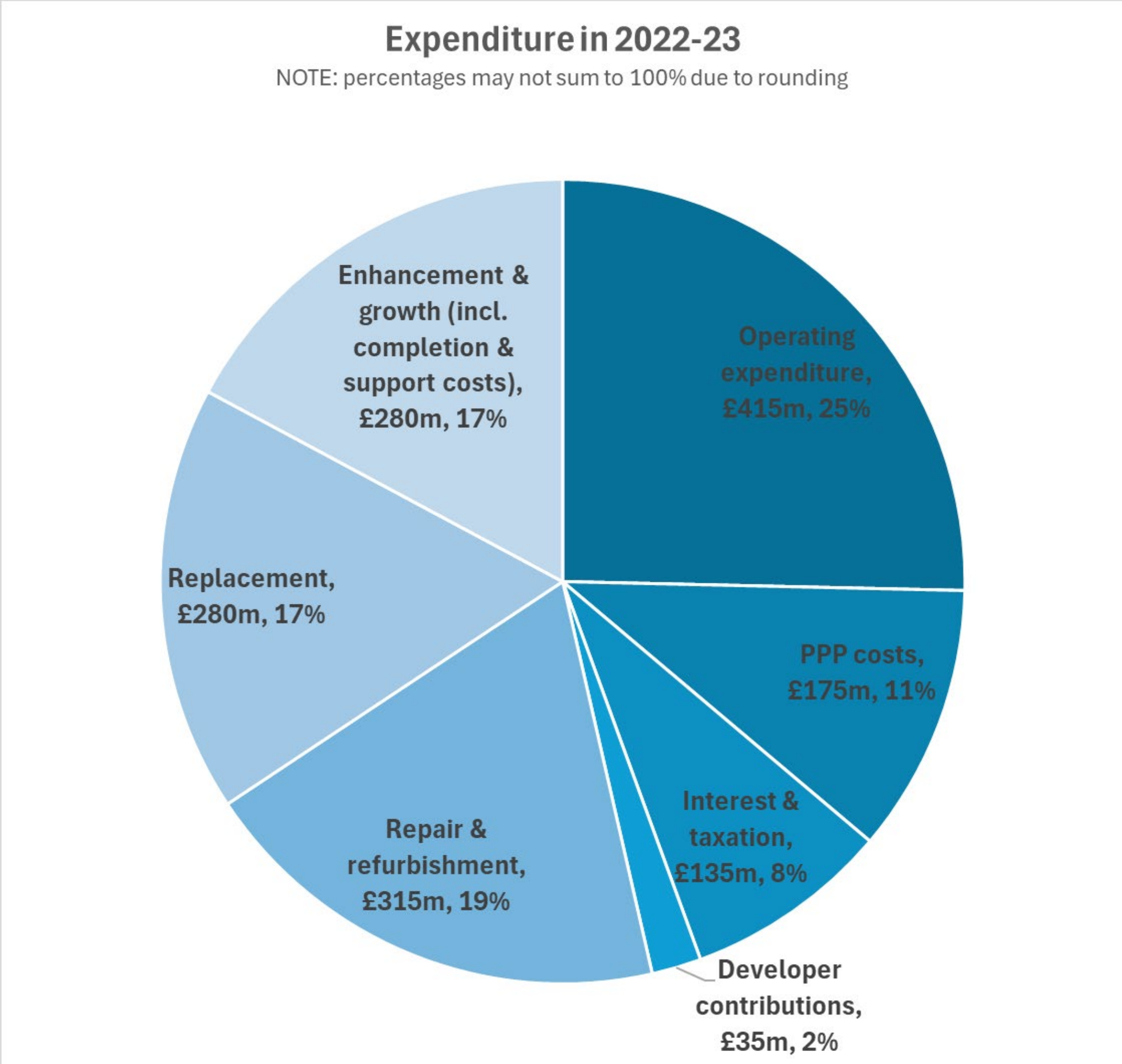
Scottish Water spends in the region of £1.6bn every year to provide water, sewerage and drainage services. This is required to operate water, wastewater and drainage networks, to maintain its current assets, and to invest in improvements and expansions of the infrastructure to meet new demand. Appendix 5 defines each category of expenditure.

Some of Scottish Water's costs such as operating expenditure and PFI expenditure[95] are covered in the regulatory period in which they are incurred. As such, current customers bear these costs.

Other costs such as investment to improve levels of service or meet new demand and asset replacement relate to investment in long-lived assets and are therefore spread over the lifetime of the new asset created. Figure 11 below provides a breakdown of Scottish Water's expenditure by each area based on its expenditure reported in 2022-23. Over 15% and 35% of Scottish Water's expenditure are, respectively, for investment in new assets (growth and enhancement), and for replacement, repair and refurbishment of assets. These costs are effectively paid for by a combination of revenue in the regulatory period and borrowing. As such, these costs are paid for by current customers and future customers in the form of the repayment of the debt and interest on the outstanding balance of debt.

[95] Regular payments to third-party organisations providing wastewater assets and services on behalf of Scottish Water for a period under legacy contracts.

Figure 11: Expenditure in 2022-23



BALANCING COSTS BETWEEN CURRENT AND FUTURE CUSTOMERS

We set charge caps consistent with the lowest reasonable overall cost incurred by Scottish Water in delivering Scottish Ministers' objectives. These caps are consistent with our assessment of the revenue that Scottish Water requires to cover the efficient[96] cost of providing water and wastewater services and delivering the investment required.

Setting charge caps that ensure the water industry remains appropriately funded for the long-term raises two intergenerational issues that relate to the appropriate balance of costs of providing water services between current and future customers. These issues cover:

- the use of borrowing; and
- the approach to paying for asset maintenance.

[96] An improvement in efficiency is defined as either a reduction in costs with no deterioration in service; or maintaining costs, while improving service.

We discuss these two issues in turn below.

The use of borrowing

Scottish Water increases the value of its asset base each year by investing in new assets (i.e. enhancement, growth and asset replacement investment). The value of the asset base also reduces in each year to reflect the usage of those assets (i.e. the annual charge for economic depreciation)[97]. If long-term asset replacement investment equals the economic depreciation of those assets, then the value of the asset base grows only as a result of the enhancement and growth investment in each year. To spread the cost of that enhancement and growth investment over current and future customers, Scottish Water raises debt to finance a proportion of that enhancement and growth investment.

Only customers or the taxpayer (in the form of Government grants) can meet the cost of any new investment Scottish Water undertakes. Borrowing is used to spread costs between current and future customers given the investment and the service improvements it provides for years into the future. While borrowing reduces the need for significant increases in charges in any given year, it is not a substitute for raising revenue over the medium to long term.

For the water industry to be financially sustainable new borrowing should only be used for incremental expenditure. Ultimately if new borrowing is systematically used to cover the cost of anything other than true increments to the asset base,[98] future customers would be left paying for more than their appropriate share of the costs.

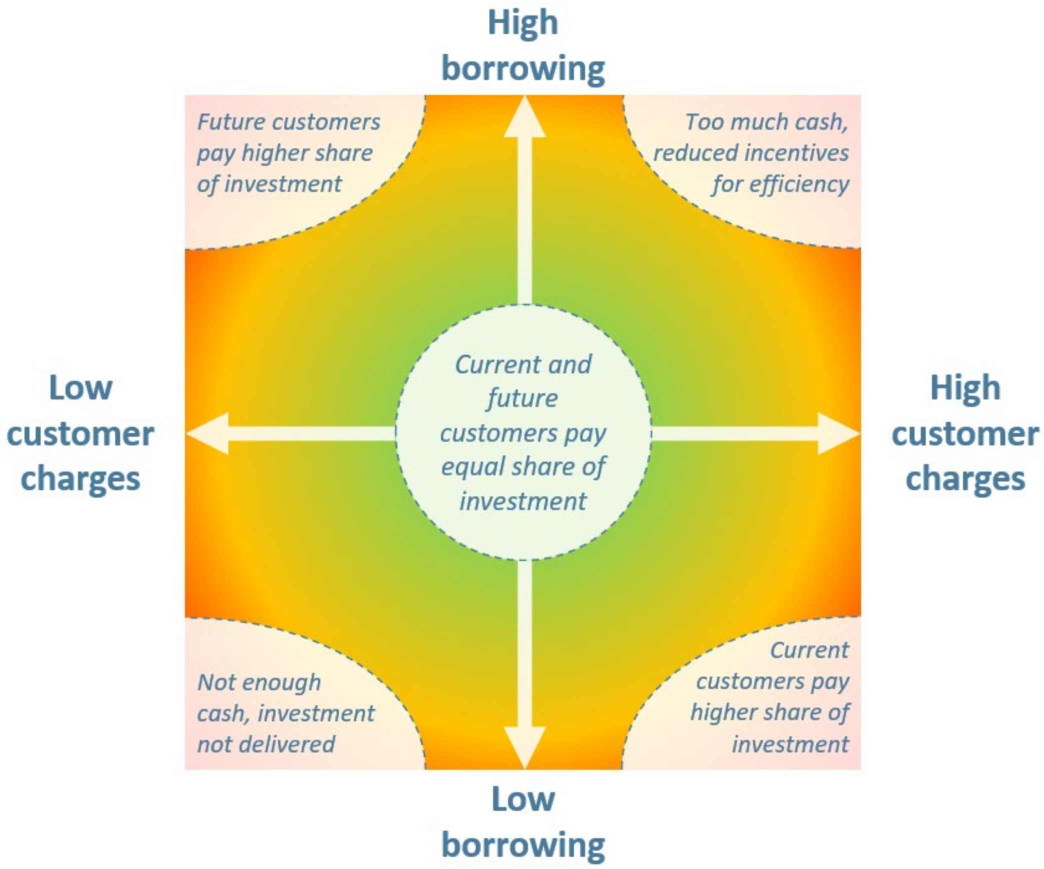
Given the climate change adaptation and mitigation challenge and environmental and drinking water quality improvements, it is reasonable to expect enhancement capital expenditure in the water industry to continue at least at current levels for the foreseeable future. This raises the question about the appropriate level of borrowing and debt consistent with an industry that remains on a sustainable footing and can meet current and future investment needs.

Balancing the current level of customers charges and borrowing is therefore critical to ensure financial sustainability and intergenerational equity (i.e. current customers pay a fair share towards the cost of assets and their financing). As shown in Figure 12 below, an excessive use of borrowing results in costs being passed disproportionately onto future customers who will need to repay that borrowing and associated interest through charges. Too little borrowing could mean that current

[97] An annual charge to customers for the usage of the asset. It represents the average annual cost of replacing an asset from commissioning to the point at which it is decommissioned and replaced with an alternative (optimised) means of providing the service.
[98]Improvements beyond the optimised solutions that could be achieved for the previously committed capital, adjusted for inflation.

customers are contributing towards a higher share of the upfront cost of investment than future customers.

Figure 12: The balance between customer charges and borrowing.



We take into consideration Scottish Water's financial strength, which relates to the ability to pay for investment and service existing debt, when assessing its capacity to borrow. Our approach to assessing Scottish Water's financial strength is consistent with the approach used by other economic regulators[99] and credit rating agencies, who monitor the creditworthiness of utilities and provide rating reports for debt investors.[100] It is also consistent with the approach adopted in SRC21.

In setting charge caps, we propose continuing to target and monitor Scottish Water's level of financial strength using a suite of financial ratios including:

- Cash interest cover post maintenance expenditure, which measures the ability to meet interest expenditure after paying for operating and maintenance expenditure and is defined as:

$$\frac{Revenue - Operating\ costs - PFI\ costs - Maintenance}{Interest\ paid}$$

[99] Ofwat (2023), '*Monitoring Financial Resilience report 2022-23*', 26 October 2023.
[100] Moody's (2018), '*Rating Methodology: Regulated Water Utilities*', 8 June 2018.

- Gearing, which measures the company's borrowing relative to the total assets owned by the company as a proxy for the capacity to raise additional debt and is defined as:

$$\frac{Net\ debt\ (total\ debt\ less\ cash)}{RCV\ (regulatory\ capital\ value)}$$

On this latter measure, we propose using a shadow regulatory capital value for Scottish Water to allow for comparability with companies in England and Wales. We set a shadow regulatory capital value for the 2006-10 regulatory period; however, we moved away from this approach when we decided that we were not going to set price limits with reference to a regulatory capital value (the approach in England and Wales). In doing so, it meant that there is no longer a measure of gearing that allows comparisons to the financial strength of the companies in England and Wales on a like-for-like basis. We will work with Scottish Water to update this.

Charging for asset maintenance

This second intergenerational issue is how and when asset maintenance investment (the investment that Scottish Water undertakes to maintain its existing assets) should be paid for.

In SRCs before SRC21, we allowed for asset maintenance costs in charges based on the efficient short term cash needs identified for the regulatory period. This short-term cash-based approach was designed to ensure that Scottish Water had a strong incentive to deliver efficiency improvements. In SRC21, we recognised that this approach was not consistent with ensuring customers pay for the assets they rely on over the life horizon of the assets. We also recognised that this approach would not encourage an appropriate focus on the sustainable management of the asset base.

Given the long-life horizon of the asset base in the water industry, such an approach would risk:
- under-provisioning for the full replacement costs of assets, effectively undercharging current customers for the use of the assets and transferring costs to future generations; and
- placing pressures on future charges, recognising that assets reaching the end of their life incur higher costs associated with their repair, refurbishment and ultimately replacement.

In SRC21, Scottish Water, working in collaboration with us, conducted a top-down analysis of its asset base, in which the replacement cost and estimated lifetime of asset categories were used to calculate an 'economic depreciation' for Scottish Water. We define economic depreciation as the average annual level of replacement consistent with replacing assets at their end of life and maintaining services in perpetuity. This analysis led to the conclusion that investment in replacing assets would need to increase significantly over the coming years and decades and that water charges should transition to recovering the full level of economic depreciation.

Recognising these issues and our statutory duty to both current and future customers, the most appropriate approach is for customer charges to cover the full economic depreciation of assets, recognising that the cash required to maintain assets will ultimately align to this level over the medium to long-term. We therefore propose to continue transitioning charges towards the full level of economic depreciation, recognising that a one-off adjustment would likely result in a significant increase in charges (estimated at over 40% in real terms in SRC21)[101] and may also lead to a surplus of cash in the short term, which may reduce the incentives for efficiency.

During the transition towards charging customers for the full economic depreciation of water and wastewater assets, there is an accumulated shortfall (or increased deficit/liability) based on the difference between the economic depreciation and the cash available for asset maintenance. This shortfall will ultimately need to be met by future customers. The financial ratios set out in the previous section do not account for the impact of such liability and we therefore propose that Scottish Water measures and report this liability annually, alongside these financial ratios.

Finally, the Commissioning letter asks that our Draft Determination sets out a range of possible charge paths. We expect Scottish Water to explain the implications of each charge path on the length of time it will take to transition to recover the full economic depreciation in charges and the resulting replacement deficit from the proposed charging levels.

10.3. Proposed approach

As discussed above, we propose to use financial ratios to measure financial strength over time consistent with the approach adopted in previous SRCs.

Regarding asset maintenance expenditure, and in line with our statutory duty to promote the interests of both current and future customers, we propose to continue transitioning charges to reflect the full level of economic depreciation. While it is appropriate and prudent to continue this transition, insights from the 2021-27 regulatory period have highlighted areas for improvement. One critical improvement is the development of detailed bottom-up evidence for future asset replacement needs, which will complement the top-down analysis undertaken for SRC21.

We therefore expect that while Scottish Water will continue to build an understanding of long-term replacement costs, Scottish Water should set out the maintenance expenditure it plans to deliver throughout the 2027-33 period as part of the investment baseline discussed in chapter 14. This would include explaining what measurable outputs would be delivered across different asset categories and the impact this will have on the underlying condition of the asset base. The medium and long term consequences of not making this investment should also be clear and measurable.

[101] This is in line with the transition of charges introduced for the SRC21 regulatory period. This analysis suggested that suggested real price increases of 2.0% per annum up to 2040 may be required to ensure a sustainable industry.

10.4. Assessment of the proposed approach

Our assessment of the proposed approach takes account of three areas:

- the expectations of Scottish Ministers set out in the Commissioning letter;
- developments to date in this regulatory period (SRC21); and
- the extent to which Scottish Water meet the proposed principles for SRC27 (see section 5.5).

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

The Commissioning letter sets a clear expectation on WICS to ensure that there is a stable and sustainable funding regime for asset maintenance, recognising the prevailing economic conditions and forecast.

The Commissioning letter has also requested that the Draft Determination set out a range of possible charge paths for the services provided by Scottish Water. The paths should set out progress towards delivering the objectives of Scottish Ministers and highlight the varying levels of service failure risk associated with each path over the short, medium, and long term.

We consider that the different charge paths could show the pace and extent to which the transition to a sustainable level of economic depreciation could be achieved over the regulatory period and the implications of those different paths in terms of levels of risk and impact on future service levels.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

We have asked Scottish Water questions about the detailed evidence of what asset replacement, repair and refurbishment investment will be undertaken.

The proposed approach of continuing to transition charges to cover the full cost of maintaining the asset base, combined with detailed information on the actual maintenance investments planned for the next regulatory period, will improve accountability.

THE EXTENT TO WHICH THE PROPOSED APPROACH MEETS THE PROPOSED PRINCIPLES FOR SRC27

Table 7 provides our assessment of our proposed approach against the principles set out in section 5.5.

Table 7: Balancing costs option assessment.

Principle	Assessment
Evidence and analysis	The proposed approach will require detailed analysis of the asset maintenance Scottish Water plans to deliver during the regulatory period as part of its plan and the impact this would have on current and future regulatory periods.
Accountability	The proposed approach would require Scottish Water to set out in advance of the period what it plans to deliver, allowing us to monitor Scottish Water's performance against the plan and ensure appropriate accountabilities.
Flexibility	The proposed approach increases Scottish Water's flexibility to adjust the asset maintenance investment it plans to deliver through the regulatory period.

QUESTION FOR CONSULTATION

Do you have any views on our proposals in relation to balancing the costs between current and future customers?

11. Form of control

11.1. Overview of Chapter

This chapter provides our proposals for the mechanism of limiting charges. It covers the following areas:

- Background (section 11.2);
- Options available (section 11.3);
- Assessment of the options (section 11.4); and
- Preferred option and consultation questions (section 11.5).

11.2. Background

The Commissioning letter from Scottish Ministers requests that WICS "sets out a range of possible charge paths for both the domestic and non-domestic sectors for the services provided by Scottish Water".[102] However, there are various options for the way in which we express these paths, which we describe as the 'Form of Control'. This chapter considers options in relation to the form of control over the regulatory period, as described in Table 8.

Table 8: Form of control definitions

Option	Definition
Revenue cap or charge cap	**Revenue cap:** Sets the maximum percentage change that Scottish Water can apply to revenues. This means that revenue available is independent of factors such as growth in the customer base or change in water consumption. **Charge cap:** Sets the maximum percentage change that Scottish Water can apply to customer charges. This means that revenue available depends on factors such as growth in the customer base or change in consumption.
Real cap or nominal cap	**Real cap:** Sets the charge/revenue cap relative to inflation. **Nominal cap:** Sets the charge/revenue cap in cash terms. **Hybrid cap:** Sets the charge/revenue cap using a combination of both real and nominal charges.
Annual cap or cap over the period	**Annual cap:** Sets a charge/revenue cap for each year of the regulatory period. **Cap over the period:** Sets a cumulative charge/revenue cap for the duration of the regulatory period.

In assessing whether to adopt a particular form of control, we have considered the following issues:

[102] Scottish Government (2024), '*2027-33 Commissioning letter*', June 2024.

- who is best placed to manage the risk (between Scottish Water and its customers) and the associated incentives
- consistency with Scottish Government's Principles of Charging; and
- the level of flexibility to respond to external changes.

11.3. Options available

REVENUE CAP VS CHARGE CAP

Under a charge cap, Scottish Water bears and manages the volume risk. This means that if customer growth is lower than forecast over the regulatory period then revenues will also be lower. The cash available for Scottish Water to invest and deliver service improvements is reduced with the required investment delayed to future regulatory periods.

Under a revenue cap, customers bear the risk of customer growth being lower than forecast. This means that if customer growth is lower than forecast over the regulatory period, then charges need to increase above the level originally forecast to provide Scottish Water with the allowed for revenue to invest in service improvements.

REAL VS NOMINAL CAP AND ANNUAL VS OVER THE PERIOD

There are two other decisions relating to the form of price control. These relate to setting a real versus a nominal charge cap and setting an annual cap versus a cap over the period. Table 9 sets out the different options based on our experience from previous SRCs.

Under a real cap, customers bear the risk as charges/revenues are set relative to inflation. Under a nominal cap, Scottish Water bears the risk as charges/revenues are set in cash terms irrespective of inflation. A nominal cap places a stronger incentive on Scottish Water to manage inflation risk such as supply chain costs or volatility of energy prices, but it may also provide less certainty on the amount of investment available, recognising that if inflation is higher than forecast then Scottish Water would bear that additional cost and the funding available for investment would pay for fewer investment projects. It may also result in sub-optimal investment decisions, e.g. if Scottish Water must focus on minimising expenditure over a regulatory period, rather than the overall cost of maintaining assets over the lifetime of the asset.

Table 9: Form of control approaches in previous SRCs

Option	Real cap vs nominal cap	Annual cap vs cap for the period
Current approach	Real	Cap for the period
SRC15 approach	Hybrid	Hybrid
SRC10 approach	Real	Annual cap

There are several different options based on combinations of real versus a nominal cap and an annual cap versus a cap over the period, but we focus on three options based on the approaches adopted in previous SRCs.

The first option involves setting a real charge cap consistent with the SRC21 approach. The Final Determination set charges in line with an average Consumer Price Inflation (CPI)+2% each year, equivalent to an increase capped at CPI+12.6% over the period.

A second option involves adopting a hybrid approach. In SRC15, we set a combination of real charge caps and nominal charge caps for households along with an annual charge cap and a cumulative total charge cap for the period:

- Charges were capped at CPI-1.8% for the period (equivalent to six annual charge caps of CPI-0.3%).
- In the first three years of the regulatory period charges were capped at 1.6% in nominal terms.

The cap over the period meant that, if inflation was higher than forecast in the first three years of the period, then the charge cap could flex over the remainder of the period subject to the overall cap of CPI-1.8% over the period.

This approach provided customers with certainty over charges in the first three years of the period and included an adjustment mechanism in the final three years of the period that protected Scottish Water from the risk of higher than forecast inflation. The approach was developed based on customer research.

Finally, a third option involves setting a real cap for each year of the regulatory period consistent with the approach we adopted for SRC10.

11.4. Assessment of the options

REVENUE CAP OR CHARGE CAP

We are mindful that Ministers' draft Principles of Charging set three relevant principles when assessing the most appropriate form of control:

- Principle 1: stable charges.
- Principle 2: full cost recovery.
- Principle 5: fair, equitable and affordable charges.

A charge cap would meet Principle 1 but may not achieve Principle 2 and 5 if there are significant variations in customer numbers or volumes. Most households in Scotland are unmeasured and charged based on council tax bands. The number of domestic customers[103] is relatively predictable and there is reasonable certainty regarding the number of connected properties. Around 80% of non-households are charged based on a volumetric charge which means that non-household volumes are more difficult to predict over the regulatory period. Therefore, under a revenue cap if non-household consumption is lower than forecast, wholesale charges would have to increase to achieve the same fixed amount of revenue as part of the revenue cap. A revenue cap that operates in such a way could therefore result in volatile charges year-to-year. As such, we consider that such an approach would not be fully consistent with the principle of price stability and potentially also principle 5 if charges are fluctuating materially year-to-year.

From a cost recovery standpoint, as a high proportion of Scottish Water's costs are fixed over the short to medium term (given the fixed costs of operating and maintaining the water infrastructure), there is a risk that if volumes are materially lower than forecast, Scottish Water may not recover the full cost of providing the service.

In terms of the volume risk, we consider that Scottish Water should be able to manage the risk of lower than forecast non-household consumption within the regulatory period. However, to mitigate this risk, we propose reviewing actual non-household volumes against the forecast level at the end of the regulatory period. If Scottish Water recovers materially lower revenue due to lower volumes, we would apply an adjustment to charges over the next regulatory period to cover this shortfall.

Therefore, we propose to set a charge cap for household and non-household charges. Such an approach would be consistent with the principle of price stability and full cost recovery.

NOMINAL CAP OR REAL CAP

Applying a real charge cap reduces the inflation risk to Scottish Water. In previous regulatory periods, including SRC21, we set charge caps relative to the Consumer Price Index (CPI) measure of inflation. This reduced risk for Scottish Water because it means that if its cost base increased relative to the forecast due to higher-than-expected inflation, then customer charges and revenue would

[103] Customers council tax bands are converted into a common Band D equivalent for charging purposes. The change in Band D equivalents is relatively predictable.

increase by a similar percentage. This may present an affordability challenge (as per charging principle 5); however, such challenges can be mitigated through setting an overall cap over the period (see the next sub-section).

While this approach reduces the inflation risk to Scottish Water, we also recognise that there is a residual risk that Scottish Water will have to manage as its cost base may not move exactly in line with the weighted basket of goods captured by CPI.

Applying a nominal charge cap instead requires making an assumption on inflation in advance and then fixing the charge cap in line with this assumption. If actual inflation was higher than the inflation assumed in the nominal cap, then the difference would need to be absorbed by Scottish Water through additional efficiency or may involve delaying or re-profiling the investment. On the other hand, if actual inflation was lower than assumed in the nominal cap, then Scottish Water would benefit from the difference and customer charges would be higher than would otherwise be the case.

A hybrid approach, as per the approach adopted in SRC15, aims to strike a balance by providing customers with more certainty over charges in the short term—when inflation is relatively easier to forecast—while mitigating inflation risk for Scottish Water in the medium to long term by linking charges to inflation throughout the regulatory period.

To summarise, as discussed above, while a nominal charge cap approach provides certainty for customers, it may place a disproportionate level of inflation risk on Scottish Water, especially recognising the high inflation experienced in the UK during this regulatory period. If Scottish Water is unable to absorb the additional inflation, then customers may be worse off given the likely impact on levels of investment and customer service. For this reason, we do not consider that a nominal cap is a credible option and propose instead to adopt a real charge cap with reference to the CPI for SRC27.

ANNUAL CAP OR CAP FOR THE PERIOD

In deciding whether to apply an annual cap or a cumulative cap over the regulatory period, we evaluate which approach offers greater flexibility.

An annual cap gives customers greater certainty over annual charges but limits Scottish Water's flexibility to adopt a different profile of charges from that set out in the Final Determination. For example, if Scottish Water re-profiled charges in the early years of the regulatory period (e.g. in response to external factors such as the cost of living crisis in this regulatory period), then Scottish Water would not be able to recover at least some of the shortfall of revenue in later years of the period. This could ultimately impact levels of service if it causes delays to planned investment (unless the cash shortfall is fully absorbed by Scottish Water through greater efficiencies). As such, a cap over the period provides greater flexibility for Scottish Water to adjust the profile of charges as required, which could help meet charging principle 5 on fair, equitable and affordable charges.

For completeness, we assess the options against the three areas:

- the expectations of Scottish Ministers set out in the Commissioning letter;
- developments to date in this regulatory period (SRC21); and
- the extent to which Scottish Water meet the proposed principles for SRC27 (see section 5.5).

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

The Commissioning letter does not set specific expectations for the form of control adopted for SRC27.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

Experience from this regulatory period has demonstrated the advantages of setting a cap over the period. This approach has allowed Scottish Water to respond to the cost of living crisis by increasing charges below the annual average cap during the first three years of the regulatory period.

THE EXTENT TO WHICH THE OPTIONS MEET THE PROPOSED PRINCIPLES FOR SRC27

Table 10 provides our assessment of the options against the principles set out in section 5.5.

Table 10: Form of control options assessment

Principle	Assessment
Evidence and analysis	All options will require evidence on the investment requirements underpinning the proposed profile. All options will require evidence on the consequences if Scottish Water deviates from that profile.
Accountability	Option one of the current approach enhances the accountability of Scottish Water given that it has to decide and explain the profile of charges based on the real charge cap over the period.
Flexibility	Option 1 provides more flexibility, allowing Scottish Water to profile charges in response to material changes or specific circumstances (e.g. the cost of living crisis).

11.5. Preferred option, next steps and questions for consultation

To support the long-term sustainability of the industry and enable Scottish Water to meet Ministerial Objectives, it is critical that Scottish Water has clarity and a degree of flexibility over the revenue it can collect from customers. For this reason, we propose to set a cumulative charge cap over the six-year period, similar to the approach adopted in SRC21.

The additional flexibility associated with a cumulative cap for the period could result in some variations in the cash available over the period compared to the Final Determination, depending on the annual profiling of charges. For this reason, if, at any point during the regulatory period, Scottish Water were to apply a charge profile different to that assumed in the Final Determination, we would require Scottish Water to explain the short and long term implications of the difference (e.g. a result of front-loading versus end-loading price changes).

We also recognise that, through Scottish Water's customer engagement and research programme, a preference for a different approach may be identified. Should this engagement result in a clear preference for an alternative approach, then we would be open to considering an alternative to the option proposed above.

QUESTION FOR CONSULTATION

Do you have any views on our proposed form of control?

12. Cost assessment

12.1. Overview of Chapter

Our role is to set charge caps consistent with the lowest reasonable overall cost of meeting the Objectives of Scottish Ministers. This chapter covers how we propose to assess these costs. It covers the following areas:

- Background (section 12.2);
- Options available (section 12.3);
- Assessment of the options (section 12.4); and
- Preferred option, next steps and consultation questions (section 12.5).

12.2. Background

As set out in chapter 10, Scottish Water spends in the region of £1.6bn to:

- operate water, wastewater and drainage networks;
- maintain its current assets; and
- to invest in improvements and expansions of the infrastructure to meet new demand.

Appendix 5 defines each category of expenditure.

Through the Strategic Review of Charges, we assess the efficient level of Scottish Water's costs to set charge caps. We then monitor performance against the forecasts and allowances made in the Final Determination. In SRC21, we adopted a high-level approach to cost assessment based on aggregating expenditure into two broad categories: Tier 1 and Tier 2. During the regulatory period, Scottish Water then further split Tier 1 into Tier 1 and Tier 1a.

Table 11 sets out the definition of Tier 1, Tier 1a and Tier 2.

Table 11: Tiers of expenditure applied in SRC21

Category	Definition
Tier 1	Broadly recurring expenditure (operating expenditure, PFI contract fees, interest costs, taxation and reasonable cost contributions to developers)
Tier 1a	Responsive repair and refurbishment expenditure
Tier 2	Expenditures associated with enhancement, growth, asset replacement and planned repair and refurbishment investment

It is standard regulatory practice to begin from reported expenditure, which is referred to as the base year for the Strategic Review of Charges. Therefore, we assessed the efficient level of costs for Tier 1 expenditure (now covering Tier 1 and Tier 1a) based on reported expenditure (expressed in 2017-18 prices, CPI-based) less the assessed scope for efficiency of 1% per year in real terms. The annual efficiency challenge of 1% was based on the productivity improvements observed in the water industry in England and Wales over the period from 1994 to 2017.[104]

The financial model for SRC21 included a breakdown of each category of expenditure included in Tier 1; however, we did not model the profile in detail. For example, we did not forecast the impact of the expiry of the Grampian and Highland PFI contracts, which led to a reduction in PFI fees and an increase in operating expenditure and capital maintenance expenditure. Instead, our approach involved assessing costs 'in the round' based on reported expenditure less an efficiency challenge of 1% in real terms – even on areas where Scottish Water has limited control over the level of expenditure such as local authority rates and interest costs – and empowering Scottish Water to decide how it achieves the overall efficiency challenge.

We assessed the allowed for cost of Tier 2 investment based on top-down investment allowances for asset replacement investment, enhancement and growth. As set out in section 4.3, we expected greater definition of the Tier 2 investment programme over time through the investment planning and prioritisation group (IPPG, now named the Scottish Government Investment Group, SGIG).

12.3. Options available

We consider two options for cost assessment:

- apply the Tier 1, Tier 1a and Tier 2 distinction as per the approach followed SRC21; or
- consider expenditure on a disaggregated basis.

In both options, we propose using 2024-25 as the base year for the Strategic Review of Charges. Therefore, we would start from reported actuals in 2024-25 and then apply adjustments, including through removing any one-off items of expenditure in the year.

In relation to inflation, we propose expressing expenditure in a 2024-25 price base (based on financial-year average) for SRC27.[105] We expect Scottish Water to provide evidence of the appropriate published inflation index or indices that should apply to each category of expenditure and its forecasts for inflation for the regulatory period. The use of a published inflation index or

[104] This is based on a study published in 2017, which estimated that the UK water companies improved by no more than 1% a year in the period 1994 to 2017. Frontier Economics, Saal, D. (2017), '*Productivity improvements in the water and sewerage industry in England since privatisation*', 29 September 2017.

[105] For its draft Business Plan, Scottish Water will use 2023-24 price base and update this to 2024-25 for its final business plan.

indices will ensure that we can adjust the financial forecasts from the Final Determination for actual inflation in a transparent manner, allowing us to understand and report on Scottish Water's performance during the regulatory period. We expect these to be based on:

- the published consumer price index inflation for operating expenditure;
- a published measure of inflation that most closely follows the inflation set out in the relevant contracts for PFI expenditure; and
- a published measure of capital price inflation for investment that Scottish Water considers closely follows the capital price inflation that it observes. We consider that there is scope for Scottish Water to examine the merits of indexing capital projects to the new infrastructure construction output prices index (COPI), which Ofwat is now proposing to adopt for the water and wastewater companies in England and Wales.[106]

OPTION 1: 'TIERS' OF EXPENDITURE

This option involves aggregating expenditure into the Tier 1, Tier 1a and Tier 2 categories and then assessing the efficient level of Tier 1 expenditure based on reported expenditure in 2024/25 less an efficiency challenge. This approach is the same as adopted for SRC21 and outlined above.

OPTION 2: DISAGGREGATED EXPENDITURE CATEGORIES

The alternative option involves assessing each category of expenditure individually and forecasting how we expect each category to change over the regulatory period. This would involve estimating the scope for efficiency for each category.

We understand that there may be changes across different categories of expenditure over time, and as such, these categories will not be regulated as fixed allocations. However, we would expect Scottish Water to document any changes through the annual updates to the delivery plan as covered in chapter 6 and chapter 14.

12.4. Assessment of the options

We assess the options against the three areas:

- the expectations of Scottish Ministers set out in the Commissioning letter;
- developments to date in this regulatory period (SRC21); and
- the extent to which Scottish Water meet the proposed principles for SRC27 (see section 5.5).

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

The Commissioning letter does not set specific expectations for any of the options considered.

[106] Ofwat has proposed an ex-post true-up for materials, plant and equipment enhancement costs between Consumer Prices Index including owner occupiers' housing costs (CPIH) and new infrastructure construction output prices index (COPI). Ofwat (2024), '*PR24 draft determinations – Expenditure allowances*', July 2024, p.141.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

Our experience to date during the regulatory period is that the distinction between tiers of investment potentially causes confusion among stakeholders. For example, Scottish Water distinguishes between responsive repair and refurbishment expenditure (Tier 1a) and planned repair and refurbishment expenditure (Tier 2). However, the distinction between responsive versus planned repair and refurbishment is unclear to us. Furthermore, our focus is on ensuring that Scottish Water's investment is efficient overall, irrespective of whether it is classed as Tier 1a or Tier 2.

We also have concerns that applying an overall efficiency challenge to Tier 1, which includes repair and refurbishment investment (Tier 1a), may result in unintended consequences. For example, in applying an overall efficiency challenge to Tier 1a, there may be an incentive to reduce repair and refurbishment investment, even if ongoing repair and refurbishment interventions are the lowest whole-life cost option consistent with the sustainable management of the asset base. For SRC27, we consider that it is important to understand the interdependencies between repair and refurbishment and asset replacement investment.

Furthermore, the aggregation of expenditure into Tiers and the approach to modelling some of the items within Tier 1 (e.g. PFI fees and interest) has made it difficult to understand and comment on where Scottish Water has achieved the required efficiencies. For example, as discussed above, we modelled PFI fees based on aggregating PFI fees (based on average expenditure of reported expenditure over 2016-17 to 2018-19) with other items of Tier 1 expenditure and then applied an overall efficiency challenge of 1% per year in real terms. However, Scottish Water's PFI fees have reduced over the regulatory period due to the PFI contracts expiring and Scottish Water bringing the former PFI assets back in house. This has resulted in PFI fees reducing, but operating expenditure increasing as Scottish Water has taken over responsibility for operating the former PFI assets. As such, without forecasting each category of expenditure individually and accounting for these movements between categories, it is difficult to understand how Scottish Water has achieved the required efficiencies.

As a final related point, we consider that it is not appropriate to apply an efficiency challenge to some of the items of expenditure within Tier 1 that Scottish Water has limited control over. These include interest, developer contributions and taxation.

THE EXTENT TO WHICH THE OPTIONS MEET THE PROPOSED PRINCIPLES FOR SRC27

Table 12 provides our assessment of the options against the principles set out in section 5.5.

Table 12: Cost assessment options assessment

Principle	Assessment
Evidence and analysis	Option 2 provides more evidence and analysis on the interdependencies between the individual expenditure items (e.g. between repair and refurbishment versus replacement) and the expected source of efficiencies to support future monitoring.
Accountability	Option 2 allows us to understand the initial forecasts in the expenditure baseline and the expected source of efficiency. During the regulatory period, we can understand deviations between forecast and actual performance in more detail. As such, stakeholders are better able to hold Scottish Water to account.
Flexibility	Option 1 provides more flexibility, but at the expense of transparency.

12.5. Preferred option, next steps and questions for consultation

For the reasons set out above, it is our intention to collect information and assess the efficient level of expenditure over the period at a disaggregated level (Option 2).

The expenditure categories we will use are:

- Operating costs
- PFI costs
- Interest
- Taxation
- Repairs
- Refurbishment
- Asset replacement
- Enhancement
- Growth
- Reasonable costs contributions (RCCs)

As set out above, we propose using expenditure from 2024-25 as a base-year and price base (based on financial year average) for the 2021-27 regulatory period.

The following chapters set out how we propose establishing the efficient level of expenditure in each area.

QUESTION FOR CONSULTATION

Do you have any views on our proposals in relation to cost assessment?

13. Operating expenditure

13.1. Overview of Chapter

This chapter sets out our proposals for assessing the efficient level of operating and Private Finance Initiative (PFI) expenditure for SRC27. It covers the following areas:

- Background (section 13.2);
- Proposed approach (section 13.3); and
- Assessment of the proposed approach (section 13.4).

13.2. Background

WHAT IS OPERATING EFFICIENCY?

Operating expenditure relates to what Scottish Water spends on an ongoing, day-to-day basis to run its business and provide water and wastewater services. It represents around a quarter of its annual expenditure (see chapter 10). Operating expenditure includes:

- employment costs;
- electricity and other utility costs;
- local authority rates and taxes;[107]
- vehicle running costs;
- the costs of billing and serving customers (including bad debt); and
- the cost of buying materials such as chemicals for water treatment.

PFI expenditure relates to regular payments to third-party organisations providing wastewater assets and services on behalf of Scottish Water for a period under legacy contracts. PFI expenditure represents over 10% of Scottish Water's annual expenditure.

We examine operating expenditure together with levels of service when considering efficiency. Economic regulators consider efficiency in terms of inputs and outputs:

- inputs in this context could relate to the resources used by the company to carry out its activities. It can be measured in terms of materials (e.g. chemicals), labour (e.g. staff costs) and capital, or levels of expenditure; and
- outputs in this context could relate to the quantity and quality of water delivered, the volume of wastewater treated, and the quality of treated wastewater discharged into the natural environment. Outputs also cover other aspects of levels of service such as the company's responsiveness to any contact it receives from customers.

[107] This covers non-domestic (or business) rates which are a tax on non-domestic properties to help pay for local authority services such as education, social care, waste management etc.

Efficiency can then be considered as one of two things:

- minimising input to achieve the same output; or
- maximising output for a given level of input.

Economic regulators in the water industry (e.g. WICS in Scotland, Ofwat in England and Wales and the Utility Regulator in Northern Ireland) have measured operating efficiency by benchmarking levels of expenditure and service performance across companies.[108] Therefore, the efficiency challenge would be two-fold:

- reducing operating expenditure to a level that matches that of the best performing companies (once adjusting for differences in operating characteristics); and
- improving levels of service to match the best performing companies.

During the regulatory period, the company would then have the incentive to beat the economic regulator's efficiency challenge, recognising that they could earn reputational (e.g. praise from the economic regulator or being top of a league table) and financial rewards (e.g. keeping the outperformance for a defined period) from outperformance. As set out in Figure 4, this regulatory approach has led to Scottish Water reducing its operating expenditure and improving levels of service over the past two decades. As a result, customer charges are 20% lower (in real terms) than would otherwise be the case through operating cost efficiencies alone. However, our regulatory approach must continue to evolve to ensure Scottish Water can make further improvements and deliver best value for customers in Scotland.

Before turning to the proposed approach to efficiency for SRC27, we consider factors that can impact on operating expenditure during the regulatory period as further background.

FACTORS THAT IMPACT ON OPERATING EXPENDITURE DURING THE REGULATORY PERIOD

There are several factors that impact on operating expenditure during the regulatory period, as follows:

- **Catch-up efficiency**: the reduction in expenditure to catch up with the leading performing company (i.e. the 'frontier') on operating expenditure performance after adjusting for differences in operating characteristics across companies. The scope for catch-up efficiency is measured as a snapshot based on historic/current expenditure across companies.
- **Frontier-shift**: recognising that even the leading performing company (i.e. the 'frontier') should continue to improve its operating efficiency in future years due to technological improvements.
- **Special factors**: the statistical models used to assess the scope for catch-up efficiency cannot account for all the operating characteristics of a company. As such, the catch-up challenge can be adjusted if the company has a unique operating characteristic not included in the models that

[108] With levels of service covering areas such as water quality and reliability (e.g. interruptions and water pressure), environmental performance (e.g. pollution incidents and non-compliant discharges), sewer flooding and customer service (e.g. customer satisfaction) and contact (e.g. time taken to respond to complaints).

adversely impact operating costs. Special factors need to meet certain criteria (e.g. materiality, management have mitigated its impact). These are now known as cost adjustment claims in the England and Wales water sector.[109]

- **Scope adjustments**: the opposite of special factors. These recognise that some of the scope of a company's activities may result in lower costs. An example for Scottish Water is household metering. As Scottish Water has a much lower rate of metered households (<0.01%) compared to companies in England and Wales, it does not incur the operating expenditure associated with reading meters, maintaining meters and billing based on meter readings. Scope adjustments would offset a special factor adjustment.
- **Real price effects**: while not necessarily part of the efficiency challenge, economic regulators recognise that the company may face input price inflation over and above that reflected in general economy-wide inflation (as measured by the consumer price index measure of inflation).

Appendix 6 provides examples of the regulatory precedent for assumptions in these areas in previous SRCs for WICS, Ofwat in the England and Wales water sector and Ofgem in the electricity and gas transmission and distribution in Great Britain.

As well as operating expenditure efficiency, which reduces the level of operating expenditure, there are other factors that impact on the level of operating expenditure during the period.

OTHER FACTORS THAT CAN IMPACT ON OPERATING EXPENDITURE DURING THE PERIOD

Several other factors will impact on the level of operating expenditure in SRC27, as follows:

- the expiry of legacy PFI contracts;
- spend-to-save initiatives;
- operating based solutions, rather than traditional capital investment solutions; and
- more widespread adoption of sustainable drainage solutions.

The expiry of legacy PFI contracts

When Scottish Water was created in 2002, it inherited 9 legacy PFI contracts. Under these contracts, third parties operate and maintain 21 facilities across Scotland for the provision of wastewater treatment and the subsequent treatment, recovery and/or disposal of the biosolids (which is a valuable resource), known as sludge, that remain from the wastewater treatment process.[110] In exchange for these services, the third parties receive regular payments from Scottish Water. The contracts stipulate how the payments are calculated covering aspects such as the inflation index applied to unit rates and the basis of charging (e.g. based on loads treated).

[109] Ofwat (2023), '*Cost adjustment claims*', June 2023.

[110] Around 40-50% of wastewater is treated by third parties under PFI contracts. 80% of the sludge that remains from the wastewater treatment process is treated, recovered and/or disposed of by third parties under PFI contracts.

As of 1 April 2024, 7 of those contracts remain with 2 contracts expiring during the current regulatory period (comprising 2 facilities) and a further 4 contracts expiring during the SRC27 period (comprising 12 facilities) as outlined in Table 13 below. It is expected that once the contracts expire, the facilities will be returned to Scottish Water's operations. For example, the Commissioning letter asks Scottish Water to consider the different options and costs for the future operating and funding of PFI assets, with an overall assumption that these assets should return to public ownership.

Table 13: Public Finance Initiative expiration dates

Site location	Contract end date	SRC period of end date
Daldowie	01/04/2026	SRC21
Dalmuir	15/06/2026	SRC21
Blackburn	30/11/2029	SRC27
East Calder	30/11/2029	SRC27
Newbridge	30/11/2029	SRC27
Seafield	30/11/2029	SRC27
Whitburn	30/11/2029	SRC27
Hatton	16/12/2029	SRC27
Banff/Macduff	25/06/2031	SRC27
Buckie	25/06/2031	SRC27
Lossiemouth	25/06/2031	SRC27
Inverclyde	29/09/2032	SRC27
Meadowhead	29/09/2032	SRC27
Stevenston	29/09/2032	SRC27
Levenmouth	30/10/2040	SRC39

The expiry of the PFI contracts and their return to Scottish Water has the following effects:

- the fees Scottish Water pays to the PFI contractor reduce accordingly; and
- Scottish Water's operating expenditure increases.

We expect the reduction in PFI fees to be larger than the increase in operating expenditure, due to the net impact of the following factors:

- the fees cover the financing costs of the PFI company, which would no longer be incurred by Scottish Water; and

- Scottish Water's operating expenditure efficiency is much improved today compared to its efficiency when it entered these contracts. As such, Scottish Water should be able to operate these assets at least as efficiently as the PFI contractor – if not even more efficiently.

However, Scottish Water has indicated that further investment is likely to be required on these assets once they return to Scottish Water's ownership to ensure their condition is acceptable and they meet legislative requirements.

'Spend-to-save' or transformation initiatives

'Spend-to-save' or transformation initiatives involve an upfront expenditure which generates savings that exceed the initial outlay (when expressed on a net present value basis, discounted based on the company's cost of capital). In 2002, we allowed for spend-to-save expenditure of £200m, which enabled Scottish Water to implement the organisation and business process changes that resulted in a sustained reduction in operating expenditure, which has more than offset the initial outlay. In SRC21, Scottish Water has introduced transformation initiatives which it considers will deliver £100m of net benefits in the regulatory period.[111]

Operating-based solutions, rather than traditional capital investment

Scottish Water may be able to deliver some drinking water, environmental or other levels of service improvements through alternative operating-based solutions (e.g. some nature-based solutions may involve operating expenditure as well as some capital expenditure compared to more traditional solutions). Such solutions may increase Scottish Water's operating expenditure but bring wider environmental and social benefits such as increased biodiversity or enhanced amenity value for customers. There is recognition that such solutions will need to become more prevalent in the water industry, given the need for companies to reduce their carbon emissions. For example, Ofwat is encouraging companies to make a step-change increase in nature-based solutions. For those that involve operating expenditure, Ofwat is allowing companies a 10-year allowance for such schemes and excluding the cost of such schemes from its assessment of efficiency.[112]

More widespread adoption of sustainable drainage solutions

Scottish Water has made progress in working with local authorities, landowners and other organisations to reduce the risk of surface water flooding and promote sustainable drainage solutions. As recognised in the Commissioning letter and through the Scottish Government's policy development work, we expect such partnership solutions to become more widespread, recognising that Scottish Water is only one party that has a role to play in the sustainable management of surface water. These partnership solutions are likely to involve a shift away from predominantly building and increasing the size of sewers and other assets, towards striking a balance between

[111] Scottish Water (2024), '*Transformation Performance (SGIG): stakeholder briefing*', May 2024.
[112] Ofwat (2022), '*Creating tomorrow, together: Our final methodology for PR24*', December, p.22.

above-ground blue-green infrastructure (which may impact operating expenditure) and below-ground solutions (which may impact on capital investment). The adoption of such solutions could result in changes in operating expenditure, as follows:

- it could be that the funding arrangements involve Scottish Water paying a fee to another organisation who takes on responsibility for implementing above-ground solutions (e.g. local authorities), which could increase operating expenditure – similar to the arrangements that Scottish Water has with local authorities for the billing and collection of household charges; and
- it may be that blue-green solutions change the balance away from predominantly capital-based solutions, towards solutions that also involve operating expenditure.

Looking forward, we expect Scottish Water to demonstrate best value for money when evaluating significant changes in operating expenditure, such as those related to the return of PFI assets, partnership arrangements, and future spend to save or transformation initiatives. Our proposed approach is outlined in section 13.3.

STARTING POINT FOR SRC27

The remainder of this chapter outlines our expectations for the evidence Scottish Water must provide as part of its business plan. This evidence focuses on two areas:

- Scottish Water's current performance and whether it has met the requirements of the Final Determination for the 2021-27 regulatory period; and
- Scottish Water's proposals for improving its operating efficiency for SRC27.

13.3. Proposed approach

We consider the options in each of the two areas separately.

EVIDENCE THAT SCOTTISH WATER HAS MET THE REQUIREMENTS OF THE FINAL DETERMINATION

The first step is to assess Scottish Water's current performance and determine whether it has met the requirements set out in the Final Determination for the 2021-27 regulatory period. As covered in chapter 12, in SRC21 we aggregated operating and PFI expenditure along with other recurring items of expenditure and called this 'Tier 1' expenditure.[113] We then set Scottish Water an efficiency challenge on Tier 1 expenditure of 1% per year in real terms. This was based on our assessment of the scope for frontier shift (as defined above), taking account of the evidence of water company performance in the United Kingdom over the period from 1994 to 2017.[114]

Our first proposed requirement of Scottish Water's business plan in this area is to provide evidence on:

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[113] WICS (2020), '*Strategic Review of Charges 2021-27: Final Determination*', 10 December 2020, page 9.
[114] Frontier Economics, Saal, D. (2017), '*Productivity improvement in the water and sewerage industry in England since privatisation*', 29 September 2017.

- whether it has achieved the Tier 1 efficiency challenge of 1% per annum from SRC21; and
- where those reductions in expenditure have been made with respect to the individual components of Tier 1 expenditure (see chapter 12).

Our second proposed requirement of Scottish Water's business plan in this area is to provide evidence on the transformation initiatives, covering:

- the expenditure on the transformation programme in real (2017-18 prices) and cash terms;
- the savings that have been generated in terms of reduced operating expenditure in real (2017-18 prices) and cash terms. We ask Scottish Water to show these savings relative to reported operating expenditure in 2020-21, the final year of the previous regulatory period which would not include any benefits from the SRC21 transformation programme;
- the savings in capital investment in real (2017-18 prices) and cash terms and how these have been assessed; and
- avoided costs in real (2017-18 prices) and cash terms, covering both operating and capital investment, and how these have been assessed relative to a counterfactual which would involve no transformation programme.

HOW SCOTTISH WATER WILL DEMONSTRATE ITS OPERATING EFFICIENCY OVER SRC27

The first step is to establish a baseline for operating expenditure. We will then roll forward this opening operating expenditure in line with:

- any step changes to this level of operating expenditure;
- the scope for efficiency; and
- forecast inflation.

In our Final Determination, and as set out in chapter 12, we plan to use 2024-25 as the starting point for operating and PFI expenditure, as this will be the most recent year of available financial data. As discussed in chapter 12, the price base for the Final Determination will also be 2024-25 prices.

There are then several different options for how we assess changes to this level of operating expenditure. One option is to adopt a similar approach to SRC21 and apply a frontier shift assumption for efficiency to Scottish Water's Tier 1 expenditure. However, as set out in chapter 12, we propose assessing the efficient level of expenditure at a more disaggregated level. As such, we do not examine this option further.

In considering other options, we have examined the approaches used by other economic regulators. Appendix 6 provides case studies from the water industry in England and Wales (Ofwat), the energy transmission and distribution in Great Britain (Ofgem), and decisions from Competition and Markets Authority (CMA) in regulation to regulatory appeals from these industries (which in the water industry involves a redetermination of Ofwat's decision).

Our proposals focus on two areas:
- step changes in operating and PFI expenditure; and
- the underlying operating efficiency challenge.

We also consider how changes to the operating expenditure baseline could be made in the regulatory period.

Step changes in operating and PFI expenditure

As discussed above, we expect there will be step change increases and decreases from the reported operating expenditure in 2024-25 due to:
- the expiry of PFI contracts;
- Scottish Water adopting operating-based solutions rather than capital solutions to deliver improvements; and
- spend-to-save and transformation initiatives, where appropriate.

We request that Scottish Water provides forecasts for operating expenditure in each of these areas for the six-year period, recognising that some of these may change during the period. We recognise that some of the proposals may change as they are developed further. As such, we expect that changes could be managed through the Scottish Government Investment Group (SGIG) governance process with these changes captured through the annual delivery plan updates. We cover this in chapter 14 on investment.

We now turn specifically to the expectations for supporting evidence in each area.

For PFI assets returning to Scottish Water, we expect supporting evidence to cover:
- the forecast change in PFI fees from the level reported in 2024-25;
- the forecast change in operating expenditure; and
- the forecast impact on repair and refurbishment and asset replacement investment (see chapter 14 on investment).

For changes to operating expenditure resulting from the adoption of operational solutions instead of capital investment solutions, or from partnership arrangements with local authorities or other third parties, we expect Scottish Water to provide more detailed information. This should include programmes of work[115] or individual projects with an annual operating expenditure of £3m or more. We expect Scottish Water to cover the same areas as would be required for all investment in section 14.3.

[115] In the case of enhancement opex, we define a programme of works as comprising investment that share the same characteristics, involves the delivery of the same group of investment outputs, involves repeatable work of similar construction requirements and risk profiles and the location of the investment is not known. For example, campaigns to educate customers on their water usage.

Turning to the topic of spend-to-save and transformation initiatives, we require Scottish Water to draw a clear distinction between:

- initiatives that form part of its proposed underlying efficiency challenge to catch-up to best practice of the water and wastewater companies in England and Wales; and
- discrete initiatives that go beyond its proposed efficiency challenge and require an initial outlay of cash to generate additional cost savings and wider benefits that more than offset the initial outlay.

We consider that stakeholder input and oversight should focus on this latter category, recognising the balance between allowing Scottish Water to run the business and enabling stakeholders to hold the company to account for delivering transformation benefits to customers and the environment. We require Scottish Water to propose criteria for determining which transformation initiatives should involve stakeholder input and oversight in this latter category, recognising that a materiality threshold is likely to be appropriate.

For these transformation initiatives, we expect Scottish Water to provide supporting evidence on:

- the initial expenditure (in a 2024-25 price base);
- any reduction in operating expenditure compared to 2024-25 (in a 2024-25 price base);
- any reduction in capital expenditure from the levels reported in 2024-25 (e.g. this may apply if the transformation initiative relates to improving existing asset management processes);
- if the initiative results in avoided costs, the forecast of expenditure in the absence of the initiative proceeding (i.e. the counterfactual) and whether this relates to operating or capital expenditure;
- the forecast of any costs avoided in terms of operating or capital expenditure against the counterfactual (in a 2024-25 price base);
- any other benefits that the transformation initiative delivers; and
- how Scottish Water will measure and report on whether the initiative is successful.

The underlying operating efficiency challenge

We would look for Scottish Water to exclude operating expenditure for operating-based investment solutions from the efficiency assessment. We consider that including these expenditures in an assessment of efficiency could discourage Scottish Water from pursuing such initiatives.

Our starting point is that it should be for Scottish Water to evidence and demonstrate its approach to assessing its efficiency challenge, the extent of the overall efficiency challenge, and how it proposes to achieve it. We would then confirm whether we agree with the assessment. We consider that this method is more in keeping with EBP&R and would ensure that Scottish Water retains ownership of the approach.

In terms of catch-up efficiency, our starting point is for Scottish Water to apply the models developed by Ofwat, including:

- the base expenditure models used by Ofwat in its price review in 2019 (PR19) (as updated by Competition and Markets Authority in the case of the four company referrals of Ofwat's Final Determinations); and
- the base expenditure models used by Ofwat in PR24 (which were confirmed by Ofwat in its draft determinations on 11 July 2024).

We also consider that there is merit in Scottish Water examining the operating expenditure econometric models used by us previously in SRC10 and Ofwat in its determinations in PR09.

These models utilise techniques such as econometric panel modelling, regression analysis, unit cost models and qualitative analysis. Appendix 6 provides more details on the structure of the proposed models.

We want Scottish Water to propose amendments to the models in two particular areas. The first area is capital maintenance expenditure – this type of expenditure is included together with operating expenditure in the modelling that Ofwat undertakes for the companies in England and Wales in PR19 and PR24.

The second area is PFI contracts. As mentioned previously, a significant portion of wastewater and sludge treatment in Scotland is currently undertaken by PFI contractors on behalf of Scottish Water. We would therefore expect that Scottish Water applies adjustments to the econometric models to ensure consistent benchmarking with the companies in England and Wales, which do not have comparable expenditure.

In line with regulatory best practice, we expect Scottish Water to triangulate the results from these established techniques, reducing the reliance placed on one model.

If Scottish Water prefers to depart from using these models, it must provide credible alternatives, clear rationale and supporting evidence for the proposed departure.

We also require Scottish Water to evidence the scope for frontier-shift efficiency improvements over the six-year period.

To build confidence on the proposed approach, we have asked Scottish Water to provide early visibility of its proposals in this area and share initial findings ahead of the draft business plan submission in June 2025. We are awaiting Scottish Water's proposals in this area. We request Scottish Water's proposed approach by October 2024 and initial findings by February 2025, ahead of the business plan submission in June 2025.

Changes to the operating expenditure baseline during the regulatory period

There may be occasions where the operating expenditure baseline needs to change during the regulatory period. This could occur if Scottish Water identifies opportunities to enter partnership arrangements or implement operational solutions instead of traditional capital investments.
If the operating expenditure baseline is unable to change during the period, Scottish Water may avoid pursuing options that increase operating expenditure, if we were to report that Scottish Water's reported expenditure was higher than allowed for. We do not consider this to be in customers' interests.

We propose that Scottish Water captures changes to operating expenditure related to implementing operating-based solutions rather than more traditional capital investment solutions through the SGIG governance process. We require these changes to be captured through the annual updates to the delivery plan as covered in chapter 6 and chapter 14.

13.4. Assessment of the proposed approach

Our assessment of the proposed approach takes account of three areas:

- the expectations of Scottish Ministers set out in the Commissioning letter;
- developments to date in this regulatory period (SRC21); and
- the extent to which Scottish Water meet the proposed principles for SRC27 (see section 5.5).

Each area is examined in turn.

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

The Commissioning letter outlines the investment challenges facing Scottish Water in SRC27 and guidance on how Ministers expect the industry to address these challenges.

The letter acknowledges that four PFI contracts are maturing during SRC27 and request that we "undertake a full examination of Scottish Water's approach to establishing the options and costs with an overall assumption that these assets should return to public ownership". Our proposed option will seek to understand changes in PFI expenditure as a result of PFI contracts maturing.

The letter also highlights the need for partnership projects in SRC27 to deliver outcomes relating to drainage, the reduction of flood risk and compliance with bathing water standards. Ministers request that WICS ensure that "the funding arrangements are sufficiently flexible so that Scottish Water can deliver to agreed timetables within partnership frameworks". As set out in the previous section, our proposed option would consider expenditure related to such partnership on a case-by-case basis and separate from any efficiency challenge imposed on the rest of the operating expenditure.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

The proposed option recognises the need to ensure there is clarity on the proposals for efficiency and the costs and benefits of any spend-to-save or transformation initiatives in the business plan. This would allow us to monitor progress in each of these areas in more detail, ensuring that customers receive the full benefits of such transformation initiatives.

THE EXTENT TO WHICH THE PROPOSED APPROACH MEETS THE PROPOSED PRINCIPLES FOR SRC27

Table 14 provides our assessment of the proposed approach against the principles set out in section 5.5.

Table 14: Operating expenditure options assessment

Principle	Assessment
Evidence and analysis	The proposed approach enables Scottish Water to more effectively demonstrate the level of efficiency it can achieve. By approaching operating expenditure at a disaggregated level, Scottish Water could provide the analysis to assure stakeholders the efficiency challenge will best serve customers and maximise the proportion of customer charges that can be invested in improving and maintaining the services Scottish Water provides.
Accountability	The proposed approach provides clarity about how Scottish Water expects to achieve the efficiency challenge allowing stakeholders to monitor ongoing progress and hold Scottish Water accountable for delivery. The proposed approach also enhances accountability over the delivery of any spend-to-save schemes during the period.
Flexibility	The proposed approach provides flexibility to enter partnership arrangements and adopt operating-based solutions, rather than more traditional capital-based solutions. It also provides flexibility for changes to the operating expenditure baseline during the regulatory period to accommodate such arrangements and solutions.

QUESTION FOR CONSULTATION

To what extent do you agree with the proposed approach to assessing Scottish Water's efficiency?

14. Investment

14.1. Overview of Chapter

Scottish Water will need to translate its contribution towards the high-level outcomes from the sector vision into tangible measures and milestones over the long term. Scottish Water will then prepare a business plan showing how it plans to meet Ministers' Statement of Objectives for the 2027-33 regulatory period as an important step in the journey towards the achievement of the long-term sector vision. As such, levels of service measures and targets will be key to understanding Scottish Water's progress towards both the Statement of Objectives and its contribution towards the sector vision. The focus of this chapter is on how we propose to set the allowed for investment consistent with Scottish Water proposals to meet these levels of service targets.

It covers the following areas:
- Background (section 14.2);
- Proposed approach (section 14.3); and
- Assessment of the proposed approach (section 14.4).

14.2. Background

WHAT IS INVESTMENT?

Investment relates to spending on maintaining, upgrading and building new water sources, pipes, treatment plants and other equipment that is required to provide water and wastewater services. Traditionally, much of this investment has involved capital investment. However, recognising the wider impact of investment on the environment, water companies are increasingly adopting more sustainable nature-based solutions. As such, references to investment throughout this chapter relate to both the traditional capital investment and nature-based solutions.

There are different types of investment, covering:
- Asset maintenance, which relates to investment to maintain existing levels of service, can be further disaggregated into repair, refurbishment and replacement expenditure;
- Growth investment, which relates to expanding the water supply and enhancing the capacity for wastewater and surface water drainage to meet new demand for these services; and
- Enhancement investment which relates to incremental improvements in levels of service.

As economic regulator, we play an important role in reviewing Scottish Water's investment plans for efficiency and then holding Scottish Water to account for delivery, ensuring that customers receive the benefits from the investment programme they have paid for.

As outlined in Chapter 4, the Scottish Government's policy development work aims to provide the water industry with the necessary tools and legislation to ensure essential water, wastewater, and drainage services can effectively address various challenges posed by climate change.

It should also take advantage of opportunities to deliver investment in a way that maximises benefits to Scotland.

We too need to recognise these challenges and opportunities and consider how we review Scottish Water's proposals for investment. This will enable Scottish Water to make appropriate and timely decisions for the benefit of customers and the wider environment. As an example, our regulatory approach should recognise that investment may no longer involve traditional capital expenditure solutions and may instead involve nature or operational based solutions which impact the level of operating expenditure Scottish Water incurs. These solutions may also provide wider benefits including enhancing the natural and social capital of Scotland. These nature-based solutions may also involve collaboration with other stakeholders and partnership arrangements (e.g. working closely with local authorities) and potentially different funding arrangements.

We provide a summary of the current approach to defining the investment programme and identify the areas that could be strengthened.

HOW THE APPROACH TO INVESTMENT HAS EVOLVED OVER TIME

Prior to the Strategic Review of Charges for the 2021-27 regulatory period (SRC21), Scottish Water and industry stakeholders would engage in a process to advise Ministers on their Objectives for the industry (known as the Quality and Standards (Q&S) process).

A key element of the Q&S process involved Scottish Water, Scottish Government, SEPA, DWQR, the consumer advocacy body at the time (Waterwatch Scotland and then Consumer Focus Scotland) developing the detailed list of projects that would support the achievement of the Ministerial Objectives. WICS would observe this process, the outcome of which was a "Technical Expression" which covered the drivers[116], outputs, outcomes[117] and regulatory deadlines for achieving compliance in relation to the enhancement and growth improvements.[118]

In parallel with the Q&S process, Scottish Water prepared a business plan which contained its proposed investment plan to meet the Ministerial Objectives. The investment plan contained

[116] An investment driver is a primary reason for investment, linking workload and output to achieve a defined standard of service. Examples include "Compliance with lead standard of 10mg/l set in EC Directive 98/83 on the quality of water intended for human consumption", "Compliance with Reservoir Safety in Flood Risk Management Act 2009", or "Climate Change Adaptation – Wastewater assets with improved resilience to climate change".

[117] Higher-level objectives that customers and society value – for example, a clean water environment.

[118] See, for example, Scottish Government (2016), '*Water industry improvements: Technical Expression 2015-2021*', 27 June 2016.

projects and programmes,[119] each of which had associated outputs[120] and costs. When determining charge caps, we would scrutinise the investment plan and provide our view of the efficient cost of delivering the outputs included in it.

Following the Final Determination, the Scottish Government would finalise the Technical Expression. Alongside the finalised Technical Expression, Scottish Water would prepare the delivery plan, which contained the finalised list of investment projects with dates for delivery and interim milestones. This detail would be provided in the form a table known as 'Table K', which would form an investment baseline to enable stakeholders to monitor Scottish Water's progress on delivery.

There were mechanisms in place to make changes to the investment programme during the regulatory period, for example:

- in SRC10, our Final Determination allowed for £180m (2007-08 prices) of unallocated investment with the expectation that the predecessor to the Scottish Government Investment Group (SGIG) would establish the process through which priorities for this unallocated investment could be identified, appraised and agreed including specifying the outputs to be delivered.[121]
- SRC15 involved setting aside further unallocated funding for investment to meet quality, environmental and service improvement objectives, to be specified through an interim review of the investment programme in 2018 (known as 'IR18').[122] This eventually resulted in £335m (2012-13 prices) of investment that was finalised through a transparent and consultative process involving stakeholders.[123]
- in previous SRCs, there was also a change control process, ensuring that the Technical Expression could be maintained as a living document and updated in light of new information. The process for making changes to the Technical Expression involved Scottish Water seeking agreement with the relevant quality regulator or Scottish Government and then Scottish Water providing a transparent audit trail for all such changes.[124] The changes were administered by Scottish Water and discussed at the predecessor to the Scottish Government Investment Group (SGIG).

Recognising that the water sector faced different long-term challenges, with high levels of uncertainty, we built additional flexibility into the investment planning process during SRC21 to allow Scottish Water to respond effectively to changes in investment priorities during the regulatory

[119] A project can be described as a customised solution applied to a specific asset, e.g. a full site replacement of a water treatment work. A programme of works can be a collection of projects involving standardised solutions which are applied to multiple assets and geographic locations, e.g. a programme to replace Motor Control Centres at multiple small treatment works.
[120] Tangible deliverables provided by an investment, driven by legislative or other requirements, which will contribute toward meeting investment drivers or outcomes.
[121] WICS (2009), '*The Strategic Review of Charges 2010-14: The Final Determination*', 26 November 2009, p.25.
[122] WICS (2014), '*The Strategic Review of Charges 2015-21: Final Determination*', 20 November 2014, p.9.
[123] Scottish Water (2018), '*Delivery Plan 2015-21: Delivery Plan Update 2018*', March 2018, p.10.
[124] See, for example, Scottish Government (2016), '*Output Monitoring Group: terms of reference 2015-2021*', 6 June 2016.

period. We worked with Scottish Water, the Scottish Government and other stakeholders to develop a new approach to identifying and prioritising investment needs and projects. The approach would be underpinned by investment appraisals for projects, setting out the scope for efficiency, the expectations of customers and regulators, the needs of the asset base, and the externalities associated with the proposal such as carbon dioxide (and equivalent) emissions and wider benefits such as augmenting natural and social capital.

As a result, the Investment Planning and Prioritisation Framework, or IPPF, was introduced, to define needs on a rolling basis (this process is now undertaken through the SGIG).[125] Some of the main aims of the approach were to:

- provide transparency for the whole investment programme and the identified long-term needs;
- be flexible and dynamic in response to emerging issues such as cost or demand shocks, new legislation, or changing financial circumstances;
- be transparent in how risks and opportunities inform Scottish Water's decisions;
- include customer engagement early in the decision-making process; and
- increase innovation.

Flexibility will remain important as the Scottish Government's policy development work concludes and impacts on investment, including in climate adaptation and mitigation, over the 2027-33 regulatory period and beyond.

However, we also need to ensure that Scottish Water defines its proposals for investment in sufficient detail to ensure that we can hold Scottish Water accountable for investment delivery during the regulatory period. Flexibility places a greater onus on Scottish Water to document and explain changes to the investment programme, including why elements of the investment programme are changing and the impact of those changes in the context of achieving the Scottish Ministers' Objectives and the contribution towards the sector vision. This will ensure that stakeholders can hold Scottish Water to account for delivery over the regulatory period on behalf of customers.

Our proposals of SRC27 reflect the findings of the lessons learned from SRC21, ensuring that we have the information that we require to set charge caps and monitor Scottish Water's performance during the regulatory period. Our proposals focus on three main areas:

- The information we require in the business plan regarding Scottish Water's investment proposals, including nature-based solutions, to allow us to set a baseline;
- How we propose to review Scottish Water's baseline for efficiency; and
- The governance process for defining the investment programme during the regulatory period.

[125] Scottish Government (2021), '*Water industry: governance note 2021 to 2027*', 23 November 2021.

In developing our proposals in these areas, we have examined the approaches used by other economic regulators, focusing on Ofwat, the Office of Rail and Road (ORR, which regulates Network Rail), the Civil Aviation Authority (CAA, which regulates Heathrow Airport) and Ofgem.
Appendix 7 provides the detailed case studies of each regulator.

Table 15 below provides a summary of the key findings from the case studies, organised by the common themes outlined above. We have not included Ofgem below, recognising the similarities between their regulatory approach and that of Ofwat.

Table 15: Summary of approaches used by other regulators

Area	Ofwat	The Civil Aviation Authority (CAA)	The Office of Rail and Road (ORR)
Overview of approach	Ofwat categorises expenditure into two areas: • Base refers to the routine year-on-year expenditure that companies incur to provide a base level of service. • Enhancement relates to investment that results in a permanent or step-change to the existing level of service. Allowances for the majority of base costs are set through econometric benchmarking. Enhancement investment is subject to a different process, which is set out below. Ofwat also requires companies to develop 25-year long-term delivery strategies, which include adaptive planning scenarios to identify no- and low-regret investment and key decision points, for when to proceed with particular investment.	The CAA sets price caps on the charges that Heathrow Airport collects from airlines. Under the terms of its licence, Heathrow Airport is required to consult on its capital programme with airlines and other relevant stakeholders. The CAA segments the investment plan into 'core' and 'development', based on the stage of project development at the time of the periodic review. Core projects are those that have passed project gateway 'G3', such that the requirement, scope and budget have already been agreed jointly by Heathrow and airlines. Development investment (i.e. projects pre-gateway G3) is subject to a separate governance process involving the airlines approving the investment.	The ORR is the economic regulator of Network Rail. It conducts a periodic review to determine what Network Rail is expected to deliver in relation to operating, support, maintenance and renewal of the rail infrastructure and the overall level funding required. Enhancement investment is developed, and the funding settlement agreed, outside of the periodic review under a 'pipeline approach' (led by the Department for Transport, rather than the ORR). The ORR continues to play a role in monitoring the delivery of the enhancements programme, but no longer establishes efficient costs in advance.[126]
Requirements for the baseline	Ofwat requires companies to prepare business plans and cases for enhancement, covering projects or aggregated programmes. Among other things, the business plans include the companies' efficient cost forecasts, and price control deliverables (PCDs). PCDs are comparable to outputs, allowing Ofwat to hold companies accountable for delivery with adjustments to their levels of funding for non-delivery.	The CAA sets out requirements for standardised information that Heathrow provides for all potential projects, covering areas such as project need, project outputs, delivery timetable. Once investment is approved, the CAA requires Heathrow Airport to provide delivery obligations (DOs) for all projects. The DOs are based on SMART objectives and cover the budget, outputs and delivery timescales. The DOs provide an objective means for establishing whether a project has been delivered in line with the original budget and delivery programme. These apply to both individuals and projects aggregated into tranches of projects.	ORR requires Network Rail to produce outputs for maintenance and renewals activities.[127] The ORR also has a baseline for asset sustainability. Asset sustainability is measured by the remaining life of an asset or an asset condition score, which is then weighted across the asset base using the replacement value of assets.
How they review investment	As part of the business cases, companies must provide evidence, covering: • the need for enhancement investment; • best options for customers; • cost efficiency; and • customer protection.[128]	In relation to 'core' investment, for the CAA's recent price control (H7), the CAA sought advice from its technical advisors. This also included reviewing how costs were developed across the programme and benchmarking selected unit rates for standardised works. In relation to 'development' investment, projects that are more complex, costly or have greater impact on airlines have further information requirements and are subject to review from independent consultants.	In examining the operations, maintenance and renewals (OMR) spend, the ORR conducts both top-down analysis and bottom-up analysis. An example of the top-down analysis relates to statistical analysis of Network Rail's unit rates for infrastructure renewals. An example of the bottom-up analysis relates to the ORR's targeted assurance reviews of Network Rail's specific activities, with one such review covering Network Rail's approach

[126] Department for Transport (2018), *'Rail Network Enhancements Pipeline: A New Approach for Rail Enhancements'*, 20 March 2018.
[127] Network Rail (2024), '*CP7 Delivery Plan: Consolidated CP7 Outcomes forecasts and targets*', 17 April 2024. The network sustainability index is set out in ORR (2023), *'PR23 final determination: supporting document - sustainable and efficient costs'*, 15 June 2023, Annex E.
[128] Ofwat (2022), '*Creating tomorrow, together: Our final methodology for PR24. Appendix 9 – Setting expenditure allowances*', 7 July 2022.

	Ofwat also requires that the companies assure the evidence. Ofwat then reviews and tests the evidence through, among other things, benchmarking of companies' enhancement investment using statistical and unit cost models.	Heathrow is expected to produce a list of projects that are due to proceed through the approval gate (Gate 3) in its investment process six months in advance of the year that the projects are due to reach the approval gate. This list forms the basis of consultation with airlines on which projects should be subject to more detailed review.	to maintenance planning and delivery and the scope for improvements in this area As well as conducting its own targeted assurance reviews, the ORR relies on external assurance. In 2022, for example, the ORR conducted a review of Network Rail's contract management arrangements, to inform the ORR's periodic review and ongoing monitoring of Network Rail's performance. The Department for Transport's approach to determining enhancement investment is predicated on the development of a robust business case compliant with and guideline by the HM Treasury Green Book.[129]
How they account for uncertainty during the investment planning process	For PR24, Ofwat will adopt a different approach for enhancement projects of more than £100m of total expenditure (TOTEX) where Ofwat has concerns over scope, cost, deliverability or complexity. This recognises that scope and cost of large projects can change as the projects are under development. If concerns relate to cost uncertainty, then Ofwat adopts an approach involving enhancement engagement with Ofwat before the investment is committed and customers bearing a higher proportion of the risk of cost overruns. If Ofwat has concerns over cost uncertainty and any other areas (e.g. scope), then it adopts an approach based on investment gates and Ofwat approving the investment once the solution is defined and presented in a solution delivery plan. In this case, Ofwat will only allow the funding to develop the project upfront.[130]	The CAA deals with uncertainty through segmenting the investment programme into 'core' and 'development' and subjecting the 'development' investment into a separate approval process based on Gates.	The Department for Transport's approach to determining enhancement investment involves five stages and four decision points (develop, design, deliver and acceptance). The decision to deliver (decision point 3) is when forecast dates are set for milestones and budgets are finalised.

We consider that our proposals reflect best practice across the regulated infrastructure sectors.

[129] HM Treasury (2022), *'The Green Book: Central Government Guidance on Appraisal and Evaluation'*, 30 March 2022.
[130] Ofwat (2024), *'PR24 draft determinations: Expenditure allowances'*, 11 July 2024.

14.3. Proposed approach

As set out above, our proposals for investment focus on three areas:

- The information that we require from Scottish Water to set an investment baseline;
- Our approach to efficiency; and
- The governance process for defining the investment programme during the regulatory period.

INFORMATION IN THE INVESTMENT BASELINE

This sub-section covers the following areas:

- overall expectations and approach for developing the baseline;
- the level of definition of the baseline; and
- expectations for the charge paths.

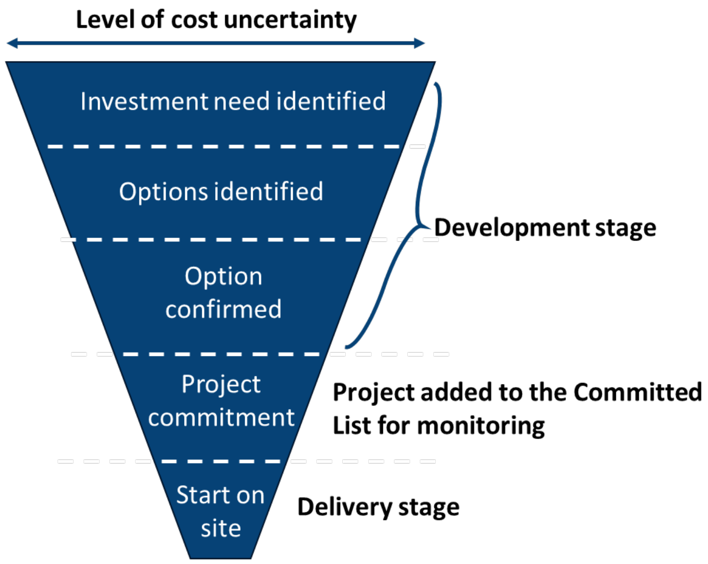
Overall expectations and approach for developing the baseline

As set out in chapter 5, in the Commissioning letter, Scottish Ministers have confirmed that they will set their Statement of Objectives in the context of the water sector vision and that we should continue to consider this as a set of outcomes towards which clear and demonstrable progress must be made.

As set out in chapter 5, we expect Scottish Water to define its contribution to the sector vision and translate this into a set of outcomes that it is accountable for over the long term. We expect Scottish Water to translate the high-level outcomes into tangible measures. Based on these measures, we expect Scottish Water to show how it plans to meet Ministers' Statement of Objectives for the 2027-33 regulatory period as an important step in the journey towards the achievement of the long-term sector vision. Scottish Water should then set the investment plan (investment outputs) consistent with making that progress and the level of resources required (inputs) over 2027-33.

Scottish Water currently defines its investment proposals on a rolling basis through the SGIG. Our proposals for the baseline for the 2027-33 regulatory period recognise that when Scottish Water publishes its business plan in February 2026, Scottish Water's investment proposals will be at different stages of maturity. For example, there will be instances where Scottish Water and stakeholders have identified a need for investment; however, Scottish Water is still to undertake the detailed optioneering to define the scope of the solution, the expected costs and the tangible outputs to be delivered. As such, there will be inherent uncertainty in Scottish Water's proposed investment programme. Figure 13 shows the different stages of Scottish Water's investment planning process (which it refers to as investment gates).

Figure 13: Investment planning process



The funnel illustrates the cost uncertainty reducing as the investment progresses through the investment planning process. We have examined how different economic regulators deal with uncertainty over scope and cost when setting the allowed for level of investment over the regulatory period. Our proposed approach draws on this best practice.

We propose that Scottish Water segments its proposals for investment into three categories:

- asset maintenance;
- enhancement and growth; and
- investment that spans SRC21 and SRC27.

The business plan guidance will provide further definition of each of these categories.

We now cover each of these in turn.

Asset maintenance

In relation to asset maintenance (which covers repairs, replacements and refurbishments), we have identified a key area for improvement: the need for detailed bottom-up evidence on future asset replacement. This would complement the top-down analysis conducted for SRC21.

Our objective for this bottom-up analysis is to understand whether Scottish Water is effectively maintaining its asset base and not storing up problems for future generations of customers (recognising the Commissioning letter expectation that Scottish Water maintains service). This analysis will also allow us to assess whether Scottish Water's proposed expenditure is efficient, including through unit cost analysis as detailed below. As such, we consider that a good outcome for SRC27 is to improve stakeholder's understanding of Scottish Water's asset base and the impact of Scottish Water's maintenance activities on that asset base.

As Scottish Water owns and maintains a large asset base, Scottish Water should know that it needs to maintain a certain number of assets in each year, although it may not know the precise location of those assets. Recognising these characteristics, we consider that there is scope for Scottish Water to present its proposals for asset maintenance at a more aggregate level based on programmes of work for different categories of assets (e.g. water mains, water treatment works).[131] In the context of asset maintenance, we define programmes of work as investment activities that relate to the same type of assets, involve repeatable work of similar construction requirements and risk profiles, and the location of the asset is not known. Some of this work may be demand driven (e.g. fixing a main that bursts), while others may be proactive. Scottish Water may find it helpful to distinguish between demand driven programmes and proactive programmes.

We consider that examining maintenance at a more aggregate programme level should enable Scottish Water to manage some of the uncertainty over scope and cost through having a large portfolio of similar activities (although some residual risk may remain).

For these programmes of work by asset category, we expect Scottish Water to show its assumptions for the:

- proposed number of maintenance interventions;
- proposed unit cost of interventions;
- overall level of expenditure; and
- impact on asset condition.

Scottish Water should link its proposed number of maintenance interventions back to its asset inventory, taking account of the number of assets and expected asset lifetimes.

In relation to asset condition, Scottish Water should provide a measure (or measures) of asset condition across its asset base and, as far as possible, translate the impact of maintenance activities on asset condition into tangible consequences that customers will understand. From our initial discussions with Scottish Water, we understand that some measures of asset condition may be more developed than others. We are in the process of understanding what approaches are possible for SRC27 and what approaches may need to be developed in further periods. We expect to comment on this further in our final methodology.

The proposal in chapter 10 to record the difference between economic depreciation and asset maintenance expenditure is another proxy for showing the impact of maintenance decisions on the

[131] Programmes of work relate to investment activities that relate to the same type of assets and involve repeatable work of similar construction requirements and risk profiles.

asset base and, ultimately, the risk to future customers who would have to meet any shortfall arising.

Enhancement and growth investment

Enhancement investment relates to incremental improvements in levels of service, while growth investment relates to increasing the supply of water and capacity available to remove wastewater and surface water drainage in response to new demand for these services. We propose further disaggregating the enhancement and growth programme (or any investment that involves an element of enhancement or growth) into a further three categories reflecting the different level of maturity of Scottish Water's investment proposals. Table 16 shows the three categories and associated information requirements.

Table 16: Tailored approach to reviewing Scottish Water's investment proposals

Investment stage	Information requirements	Our proposed approach
Investment pre-development (Pre Scottish Water internal Gate 50)	• Programmes of work • Assumptions for indicative costings and outputs	Test the reasonableness of Scottish Water's assumptions and conduct high-level benchmarking
Investment in-development/ pre-commitment (Scottish Water internal Gates 50 to 90, inclusive)	• Programmes of work • Discrete projects where investment > £3m • Forecast costs • Outputs • Interim milestones for when Scottish Water expects a decision for the project to be committed	Review the investment case (see below) in more detail, examining factors such as: • the justification for investment, taking account of the views of DWQR and SEPA • the options considered and scope • assumed costs and evidence of efficiency • wider benefits such as the impact on natural and social capital Assessment of efficiency
Investment post-commitment	• Programmes of work • Discrete projects where investment > £3m	Same as above. We consider that the assessment of efficiency would inform the

(Post Scottish Water internal Gate 90)	• Costs (in real prices and outturn prices) • Outputs • Project milestones	assessment of efficiency in the stage above, rather than revisiting the allowance for investment post-commitment.

In the context of enhancement, we define a programme of works as comprising investment that shares the same characteristics, involves the delivery of the same group of investment outputs, involves repeatable work of similar construction requirements and risk profiles and the location of the investment is not known. Examples would be a programme to remove unsatisfactory intermittent discharges or combined sewer overflows.

Investment that spans SRC21 and SRC27

As a consequence of the rolling investment programme, some of the investment in the previous two categories will span the 2021-27 and 2027-33 regulatory control periods. Of these:

- some will relate to investment that Scottish Water always planned to span the two regulatory periods; and
- some will relate to investment that Scottish Water expected to complete by the end of the regulatory period (31 March 2027) but has been delayed (e.g. due to projects taking longer than forecast during the construction phase).

In the past, this latter category would have been termed 'overhang' or 'completion' investment. Completion investment was largely a feature of the previous approach to setting the investment programme, where Scottish Water proposed an investment project at the time of the business plan while there was still high uncertainty over the scope of solution required and expected costings. In many cases, the completion investment has arisen because Scottish Water has needed to rescope the investment solution following further investigations. As a consequence of the rolling investment programme, we do not expect to see many investment projects in this latter category. However, we note that Scottish Water plans to carry forward some projects originally planned for 2015-21 into the 2027-33 regulatory period.

For investment that spans two regulatory periods, we need to ensure there is clarity over the source of funding for these projects. As such, we will require Scottish Water to identify the source of funding for each of these projects, detailing how much will be funded by the 2021-27 investment allowances and how much is expected to be funded by customers during the 2027-33 period. We will examine this in detail as part of our review of the business plan.

Interactions between the baseline and the charge paths

As set out in chapter 4, the Commissioning letter requests a range of charge paths for household and non-household customers covering drinking water, wastewater and drainage services. It also requests that SRC27 provides Ministers with the necessary information to understand the progress towards the Objectives and the level of risk of service failures associated with different levels of investment in the short, medium and long term. This includes providing an explanation on the impact of delaying investment on the resilience of services.

We have developed some principles that Scottish Water should apply in showing the charge path scenarios in its business plan, as follows:

- The charge path scenarios should have one reference scenario, with Scottish Water identifying the projects or programmes of work that would be subtracted and/or added to the reference scenario in each of the other charge path scenarios, to allow us to set a baseline on any of the charge paths.
- Other analysis may be required on alternative charge and investment scenarios to help inform the development of the Objectives of the Scottish Ministers through the SRC27 future Investment Group; however, we would not expect that these would form the request for charge paths set out in the Commissioning letter.

We will continue working with Scottish Water and the Scottish Government to develop a shared understanding and approach to devising the charge paths in a way that is consistent with Ministers' expectations.

OUR APPROACH TO EFFICIENCY

This sub-section covers how we will assess the following areas of the investment baseline for efficiency. We consider that there are three complementary approaches for assessing the baseline.

- Scottish Water's investment case;
- efficiency and benchmarking; and
- external review of a sample of projects or programmes.

Investment case

Our review of the approaches that other economic regulators use to set efficient allowances for investment identified standard information that economic regulators request from the company to justify investment proposals.

We consider that Scottish Water should provide similar information for aggregated programmes of work and projects which are in-development and post commitment, i.e. Scottish Water's internal Gate 50 onwards when Scottish Water conducts a strategic options review. We consider that Scottish Water should provide information for projects that meet certain criteria. The current criteria for projects that are added to the Committed List and subject to stakeholder oversight through an appraisal are those projects that are in excess of £3m or are novel and contentious. We consider that there is merit in retaining this threshold but will review whether a higher threshold (e.g. projects in excess of £5m) could be more appropriate to ensure that our review of investment remains proportionate and manageable. We would also welcome stakeholder views on this proposed threshold for Scottish Water providing information on individual projects.

The standard information should cover:

- the range of options considered (both traditional and non-traditional) to meet the need for an investment including the risk of not doing anything, recognising that a ‘do nothing’ option still has a cost associated with it;
- whether the investment has the support of the quality regulators, DWQR and SEPA;
- how the investment will support climate change adaptation and align with the Scottish Government’s policy development work;
- the cost-benefit analysis undertaken to select the proposed solution, taking account of factors such as the level of risk associated with the different options and benefits in terms of what the investment is expected to achieve. Scottish Water should also consider non-financial costs and benefits such as the carbon impact (both operational and embodied carbon), natural and social capital;[132]
- evidence that the proposed costs for the proposed solution are efficient, which could be evidenced through different methods such as comparisons to past projects or the use of industry cost benchmarks (efficiency is covered in more detail below) or external assurance on the robustness of the cost estimates;
- whether the investment involves partners, recognising the expectation in the Commissioning letter for Scottish Water to continue working closely with partners to identify more sustainable solutions (such as the adoption of blue-green infrastructure) and, if so, how costs will be shared with the partners including the funding arrangements;
- if Scottish Water has already engaged with communities in terms of project design, how those community views have informed the choice of the proposed solution; and
- the output(s) and benefits that will be delivered from the proposed solution and the outcomes that the investment will contribute to in the context of the Objectives of the Scottish Ministers and Scottish Water’s contribution to the sector vision.

We also consider that it is appropriate to place additional requirements on specific categories of projects. We consider that two such categories are:

- large projects, where we would propose to apply a threshold of £100m;[133] and

[132] Natural and social capital are two capitals that form the six capitals approach. The six capitals approach covers financial, manufactured, intellectual, human, social and relationships and natural capital. See Association of Chartered Certified Accountants, ‘*Integrated reporting and performance management*’, webpage.
[133] Ofwat has developed an alternative approach for investment for large schemes with a value greater than £100 million and where there are concerns around scope, cost and complexity. The approach involves enhanced engagement and the use of investment gates. Our proposed threshold is consistent with that used by Ofwat. Ofwat (2024), *‘PR24 draft determinations: Expenditure allowances’*, 11 July 2024.

- Private Finance Initiative funded projects, recognising that Ministers have requested WICS undertake a full examination of Scottish Water's approach to establishing the options and costs of the 4 PFI contracts maturing in the 2027-33 regulatory period.

For these projects, we will require Scottish Water to provide external assurance on the proposed approach and the robustness of the cost estimates.

Scottish Water already prepares an appraisal to support investment projects exceeding £3m. These appraisals are in outline form while the project is in-development, progressing to a more detailed appraisal by the time the project is ready for commitment. As such, we envisage that Scottish Water will have this information for projects in-development and post-commitment at the time of the business plan submission and should be able to provide summaries addressing the areas above as part of its business plan submission.

We recognise that the investment in-development will still need to progress through the revised SGIG governance process and that project scope and costs may change during the development of these projects. However, we will review these proposals for efficiency, to set an investment baseline in our Final Determination and set charge caps. That baseline will then provide the reference point for investment that progresses through the revised SGIG governance process. We cover this further below in the context of changes to the baseline.

Efficiency and benchmarking

In line with our approach to measuring efficiency on operating expenditure set out in chapter 13, we expect Scottish Water to propose an approach evidencing the efficiency challenge it has applied to investment. Our current expectation is that Scottish Water submits initial proposals for how it will evidence its efficiency by October 2024. We would then expect Scottish Water to refine these proposals by February 2025, ahead of the business plan submission in June 2025.

We expect that this will involve a combination of different techniques, including:

- benchmarking against the cost of comparable projects undertaken by the water and wastewater companies in England and Wales. For example, Ofwat has developed cost data sets for certain water and wastewater enhancement activities that we consider could help to understand the efficiency of Scottish Water's proposed expenditure.[134] These models are set out in Appendix 7;
- benchmarking against Scottish Water's outturn costs of delivering similar projects in previous years, adjusting for capital price inflation and an assessment of productivity improvements; and
- relying on cost information for standardised works collated by other parties (e.g. engineering consultants). For example, as part of its PR24 business plan submission, Anglian Water worked with an engineering consultant and used estimates that the consultant had collated through a

[134] For PR24 draft determination, see sections 8 and 9 *"Enhancement feeder models"* in https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/draft-determinations-models/

cost library to evidence the efficiency of the pipe unit rates used in its proposed interconnection programme of works.[135]

There are also internal and external factors that impact the level of investment that Scottish Water could deliver efficiently over the 2027-33 regulatory period. This includes the capacity of the supply chain, which covers both the availability of materials and equipment and delivery partners. This recognises that several other infrastructure companies in the UK are increasing the size of their investment programmes. For example, Ofwat's draft determinations for PR24 proposes an increase in enhancement investment for the water and wastewater companies in England and Wales from around £11 billion over 2020-25, to around £35 billion over 2025-30 – an increase of over 3 times.[136] These investment programmes will place pressure on the capacity of the supply chain since several of these companies will be seeking to draw on the same pool of delivery partners.

In SRC10, we commissioned an external report on the size of investment programme that Scottish Water could deliver efficiently at that time.[137] We will complete work to understand a top-down view of the size of investment programme that Scottish Water could deliver efficiently, recognising the capacity of the supply chain and Scottish Water's own capacity to deliver the investment programme. We propose working with Scottish Water to develop a scope of work in line with the principles of EBP&R.

Another area where we see benefit exploring further is the balance between spend on direct activities (e.g. the cost to replace an overhead) versus other items of allowances that Scottish Water adds to proposed project costs such as overheads and risk allowances. On risk, for example, we would like to understand better how Scottish Water sets the allowance for risk and how this compares to good practice, recognising that the rolling approach associated with the investment programme reduces uncertainty over project scope and some of the uncertainty over project costings at the time of commitment.

External assurance

We do not have the full technical expertise internally to review the scope of Scottish Water's solutions and the proposed costs. As such, we will require technical expertise from time-to-time to review specific areas of asset management that apply across the programme and the scope of a sample of projects on our behalf. Scottish Water is developing its approach to assurance in the context of its business plan proposals. However, we consider that there is merit in us appointing

[135] Anglian Water (2023), '*Our PR24 Enhancement Strategies. Part 1:Resilient to the risk of drought and flood*', 2 October 2023, p.25.
[136] See Ofwat (2024), '*PR24 draft determinations: Expenditure allowances*', 11 July 2023, p.2. The £35 billion is before frontier shift and real price effects. The £11 billion for PR14 is from Ofwat (2024), '*Expenditure allowances submitted by water companies in their PR24 business plans*', 8 May 2024.
[137] LECG (2007), '*Factors to be considered when determining the appropriate size of the next capital programme for Scottish Water*', December 2007. Report prepared for WICS.

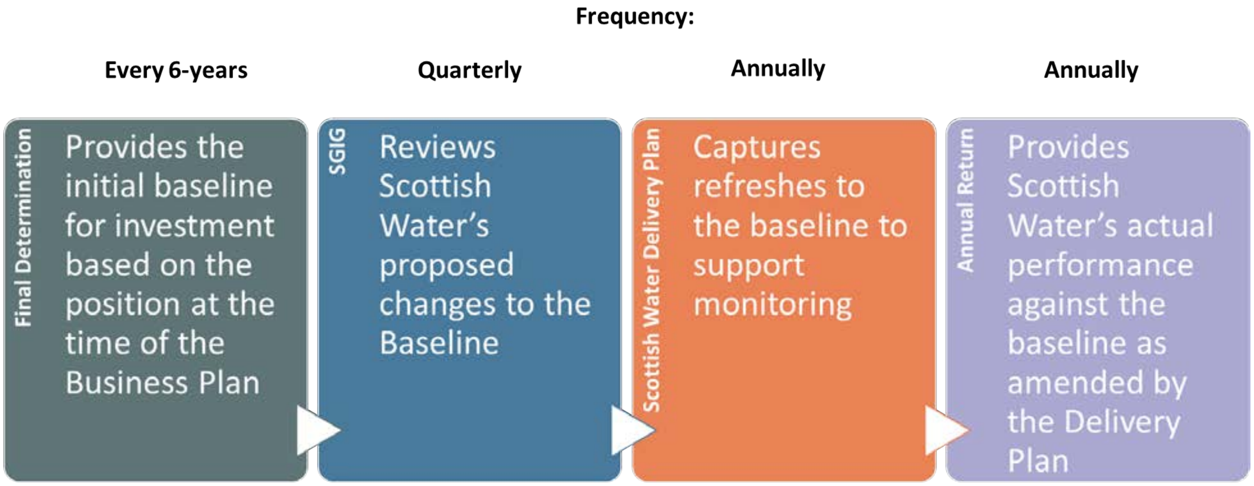
engineering and asset management consultants, to support our own review given the materiality of investment spending. As part of these arrangements, we would consult with the quality regulators (DWQR and SEPA) to ensure a joined-up approach and identify candidate projects for review. We will set out further details on our approach in the final methodology publication in December.

GOVERNANCE PROCESS FOR DEFINING THE INVESTMENT PROGRAMME OVER THE REGULATORY PERIOD

In the Commissioning letter, Scottish Ministers have set out that they expect a suitable governance structure to be developed which identifies, on a rolling basis, the outputs necessary to deliver Objectives. As such, investment that is in-development will be defined on a rolling basis through a revised SGIG governance process. We will work with Scottish Water, Scottish Government and industry stakeholders to develop this governance structure and process.

We consider that the current process could be strengthened in two ways. The first way is to enhance the linkage between the Final Determination, the SGIG governance process, Scottish Water's updates to its investment plan and the annual return, which shows Scottish Water actual performance against its forecast. As part of this, we will require Scottish Water to produce a delivery plan showing how it proposes to meet the requirements of the Final Determination and an annual delivery plan refresh before each financial year capturing the changes to the investment baseline each year as endorsed at the revised SGIG process. This revised baseline will then form the basis of our monitoring through the information we receive from Scottish Water in the annual return. This proposed approach is set out in Figure 14.

Figure 14: Linkages between Final Determination, SGIG, delivery plan and annual return



The second way that the process could be improved is for the process to include an explicit step at an appropriate point in the development stage, which would involve us reviewing the efficiency of Scottish Water's proposed investment. We would need to consider carefully when such a review should take place, recognising that if the review happens too late (e.g. just before a project is committed) then Scottish Water may have less opportunity to take on board our assessment of efficiency in relation to that project.

We would not propose to review all projects; however, we consider that we could review a sample of projects or projects that stakeholders consider merit a review. We consider that this review would enable us to fulfil our duty ensuring that prices are consistent with the lowest reasonable overall cost of meeting the Objectives of the Scottish Ministers and is consistent with the approach used by other economic regulators (e.g. the Civil Aviation Authority and Ofwat in relation to projects exceeding £100m).

We will work together with the stakeholders in the SGIG to revise the governance process in line with the expectations from the Commissioning letter.

14.4. Assessment of the proposed approach

Our assessment of the proposed approach takes account of three areas:
- the expectations of Scottish Ministers as set out in the Commissioning letter;
- developments to date in this regulatory period;
- the extent to which they meet the proposed principles for SRC27 (see section 5.5).

Each area is examined in turn.

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

We consider that our proposed approach meets the expectations set out by Ministers in the Commissioning letter.

The Commissioning letter sets out that the Strategic Review of Charges must remain cognisant of ongoing policy development and any resulting legislative changes, and that Ministers will confirm the extent of changes required in their final Ministerial Objectives. Our proposed approach provides flexibility as the Scottish Government's policy development work concludes and reflects impacts on investment, including in climate adaptation and mitigation, over the 2027-33 regulatory period and beyond.

The Commissioning letter sets an expectation that "the outputs necessary to achieve Objectives reflect the best possible value for money in terms of the improvement in outcome achieved for the investment made". Our proposals should ensure that this is the case, through:
- the requirement for a clear linkage between inputs, outputs and outcomes as part of the investment baseline; and
- our proposed approach to efficiency, which involves a combination of different methods.

As set out above, the Commissioning letter expects the overall programme to be of a size that the wider supply chain can efficiently deliver. We will work with Scottish Water on developing a scope of work, to understand a top-down view of the size of investment programme that Scottish Water could deliver efficiently, recognising the capacity of the supply chain and the competing demands placed on the supply chain, including Scottish Water's own capacity to deliver the investment programme.

The Commissioning letter also sets the expectations that Ministers will receive "the necessary information to appreciate the progress towards objectives and the level of risk of service failure associated with different levels of investment in the short, medium and long terms". Our proposed approach for the information Scottish Water will provide—including the investment baseline, guiding principles for charge paths, and the connection between maintenance interventions and asset health—should fulfil this requirement for Ministers.

The Commissioning letter also sets an expectation for "a suitable governance structure [to] be developed which identifies, on a rolling basis, the outputs necessary to deliver their Objectives." Our proposed approach is based on investment being identified on a rolling basis.

The Commissioning letter also includes other specific expectations related to investment, which we cover in Appendix 2.

DEVELOPMENTS TO DATE IN THIS REGULATORY PERIOD

The proposed approach seeks to recognise the developments to date in the regulatory period (see the Background section), strengthening the current approach to investment planning.

THE EXTENT TO WHICH THE PROPOSED APPROACH MEETS THE PROPOSED PRINCIPLES FOR SRC27

Table 17 provides our assessment of the proposed approach against the principles set out in section 5.5.

Table 17: Investment option assessment

Principle	Assessment
Evidence and analysis	Our proposed approach places the onus on Scottish Water to submit detailed evidence on the proposed investment programme, including the need for investment, the benefit or outputs to be delivered, the timescales for delivery, and the proposed costs and the scope for efficiency.
Accountability	By setting an investment baseline at the start of the period and setting our expectations for how changes to that plan should be documented and explained, we and other stakeholders will be better placed to hold Scottish Water accountable for the delivery of outputs and benefits, ensuring customers receive what they have paid for.
Flexibility	Our proposed approach continues to define investment on a rolling-basis. This provides flexibility within the baseline to respond effectively to emerging new information, better understanding of the asset base requirements, or changing priorities in the face of the multitude of challenges Scottish Water faces – including adapting to a changing climate.

QUESTION FOR CONSULTATION

Do you agree that our proposals provide the required level of flexibility for Scottish Water's investment programme, while ensuring that Scottish Water remains accountable for delivery?

15. Levels of Service

15.1. Overview of Chapter

It is important that Scottish Water makes clear and measurable commitments on the levels of service that customers can expect. Scottish Water has made significant progress on improving levels of service over the past two decades. It is now among the highest scoring companies in Scotland on customer satisfaction and outperforms the average for the water industry in the UK.[138] These measures help to ensure that Scottish Water consistently delivers high-quality service to its customers.

These levels of service measures and targets will also be key to understanding Scottish Water's progress towards both the Statement of Objectives and its contribution towards the sector vision. This will require Scottish Water to link its contributions to the sector vision's high-level outcomes and ensure that the proposed service level measures and milestones allow stakeholders to track progress throughout the 2027-33 regulatory period and beyond. As such, the focus of this chapter is on the levels of service measures and targets. It covers the following areas:

- Background (section 15.2);
- Proposed approach (section 15.3); and
- Assessment of the proposed approach (section 15.4);

15.2. Background

As set out in chapter 2, we rely on levels of service measures and targets to monitor Scottish Water's performance against its forecasts (see chapter 6 on the baseline) over the regulatory period. We then comment on its performance through our performance reporting, allowing stakeholders to hold Scottish Water to account for delivery on behalf of customers and the environment. Service measures also perform a crucial role facilitating stakeholder understanding of Scottish Water's progress towards the achievement of outcomes.

CURRENT APPROACH

There are various aspects to the service provided by Scottish Water, and there are accordingly various measures of levels of service:

- Overall Performance Assessment (OPA); and

[138] Scottish Water ranked 6th out of 22 companies from Scotland on the UK Customer Satisfaction Index (UKCSI) survey score in 2024. The Institute of Customer Service publishes the UKCSI survey score as an objective, independent perspective on the state of customer satisfaction in the UK across 13 sectors. Scottish Water scored 77.1 points out of 100 on the UKCSI compared to the average for the water sector of 70.7. See the Institute of Customer Service (2024), *'UK Customer Satisfaction Index: the state of customer satisfaction in the UK'*, July 2024, p.73 and Scottish Water's annual return for 2024, which will be published on the WICS website in late 2024.

- Customer Experience Measure (CEM).

Overall performance assessment

Ofwat introduced the Overall Performance Assessment (OPA) in 1999 as a measure to compare levels of service performance across the water and wastewater companies in England and Wales. It is a weighted basket of different levels of service measures covering water supply, sewerage service, customer service and environmental performance.

We introduced the OPA for benchmarking the performance of the three former water authorities that existed before Scottish Water was established in 2002-03 (e.g. the previous Water Industry Commissioner examined the performance of the three authorities in the customer service report for 2001-02).[139] Since 2002-03, Scottish Water has improved its performance markedly and has maintained performance at this level (see Figure 4). Ofwat stopped measuring water company performance on the OPA in 2010 for a number of reasons, including recognising that in most cases performance across the companies had reached acceptable levels on the OPA and the need to consider broader aspects of the customer experience.[140] As such, we can no longer compare Scottish Water's performance to the companies in England and Wales on the OPA measure.

As part of SRC21, we set an expectation for Scottish Water to take ownership of its performance reporting and develop OPA and other measures. In response, Scottish Water redefined the OPA into what it now calls the "New OPA".[141] 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), changing the definitions of some 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).

Customer Experience Measures (CEM)

The CEM is a measure of Scottish Water's service which combines a qualitative survey-based component, with a quantitative component measuring the volume of events and issues that impact customers. This is measured separately for Scottish Water's household and non-household (i.e. wholesale) services.

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[139] Water Industry for Scotland (2003), *'Customer Service Report 2001-02'*, October 2003.
[140] Ofwat (2009), *'Putting water consumers first – the service incentive mechanism'*, October 2009.
[141] 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 overall score compared to that in place over 2015-21.

APPROACH USED IN ENGLAND AND WALES

Ofwat now uses a number of performance metrics to assess the levels of service that companies deliver to customers and the environment. Ofwat sets 24 common performance commitments that apply to companies in England and Wales.[142] Ofwat sets the expected rate of performance improvement, as measured on the performance commitments, ensuring that they are suitably stretching taking account of expenditure allowances, historical performance and cross-company benchmarking.[143] The water and wastewater companies in England and Wales can also propose bespoke performance commitments which Ofwat reviews and decides whether to accept.[144]

In terms of performance commitments, some of the performance commitments are less applicable to Scottish Water, recognising the differences in legislation or other policy differences between Scotland and England and Wales.

We consider that there are merits in making greater use of comparisons between Scottish Water and the water companies in England and Wales, recognising that it provides an opportunity to understand Scottish Water's current performance and provides reference points for understanding the level of ambition in Scottish Water's annual targets.

THE PROCESS OF SETTING MEASURES AND TARGETS

In previous Strategic Review of Charges, we have adopted different approaches in terms of who defines the measures and who then sets the annual targets.

- in SRC06, we defined the measures based on the OPA and set annual targets in our Final Determination.
- in SRC10, we continued to use the OPA and set a target for performance on the OPA for the end of the regulatory period, leaving Scottish Water to define annual targets through its delivery plan before the regulatory period started.
- in SRC15, Scottish Water and the Customer Forum agreed on annual performance targets for the OPA before the regulatory period began.
- in SRC21, Scottish Water changed its approach, with Scottish Water's Board setting annual targets for its measures.

REFLECTIONS ON THE CURRENT APPROACH

We consider that there are several aspects of the levels of service measures that could be improved, including:

- creating a direct linkage between:
  - Scottish Water's contribution towards sector vision and the levels of service measures; and

[142] Ofwat (2024), *'PR24 Performance commitment definitions'*, webpage.
[143] Ofwat (2022), *'Creating tomorrow, together: Our final methodology for PR24, Appendix 7 – Performance commitments'*, December, p.82.
[144] Ofwat (2022), *'Creating tomorrow, together: Our final methodology for PR24, Appendix 7 – Performance commitments'*, December.

  - the levels of service measures and the delivery of the investment programme.
- there is scope to make greater use of benchmarking Scottish Water's against the performance of the water and wastewater companies in England and Wales in order to understand the level of ambition in Scottish Water's proposals;
- we have no opportunity to comment on the reasonableness of Scottish Water's annual targets before they come into effect (e.g. in terms of how they are set or the overall destination over the six-year period and the long term) and consider that these should be set out in the business plan (with any revisions reflected in the delivery plan) to provide us with an opportunity to comment;
- while management incentives (e.g. annual outperformance incentive plans (AOIP) and long-term incentive plans (LTIP)) are a matter for the Scottish Water Board and its owner, the Scottish Government, we consider that it is good practice for incentives to be set based on performance against the requirements of the Final Determination.

15.3. Proposed approach

First and foremost, Scottish Water's levels of service measures must demonstrate its progress on delivering the Objectives of the Scottish Ministers as an important step in the journey towards the achievement of the sector vision.

We expect Scottish Water to translate its contribution towards the high-level outcomes from the sector vision into tangible measures and milestones over the long term. Scottish Water will then prepare a business plan showing how it plans to meet the Statement of Objectives for the 2027-33 regulatory period.

As part of this, we consider that Scottish Water has scope to align some of its existing performance and asset measures with those in place in England and Wales. This would enable us to benchmark Scottish Water's performance against water and wastewater companies in England and Wales using current information and improving both our and Scottish Water's understanding of its comparative performance. While benchmarking offers a useful reference point, it will also be important for Scottish Water to understand customer priorities through research when establishing the measures and setting targets, where applicable.

Based on the Ofwat performance commitments, there may be scope to achieve greater alignment for the following performance measures:
- Operational greenhouse gas emissions;
- Leakage;
- Per capita consumption;
- Pollution incidents;
- Discharge permit compliance (wastewater).

- Customer contacts about water quality;
- Internal sewer flooding;
- External sewer flooding;
- Mains repairs; and
- Unplanned outages.

We will also work with DWQR to identify the scope for benchmarking measures of drinking water quality between Scotland and England and Wales, recognising the differences in water quality regulation between the two jurisdictions (which is undertaken by the Drinking Water Inspectorate (DWI) in England and Wales).

As part of its business plan, we will require Scottish Water to set annual targets on its performance measures where applicable, taking account of its proposed investment programme and historic performance.

We recognise that not all measures will have a target. One such example could be per capita consumption, which relates to how much water each person uses. It is important for Scottish Water to understand per capita consumption given that it could inform future investment decisions. However, Scottish Water may not set a target recognising that it is less able to measure per capita consumption accurately (as only a small number of customers have a water meter) and Scottish Water has fewer mechanisms available to control per capita consumption compared to the water companies in England and Wales. It will be important for Scottish Water to set out which measures have a set target, and which measures are mainly for information.

As part of developing guidance for Scottish Water's business plan, we are developing a template outlining areas that could be covered by performance measures. This template will serve as an initial view for further discussion with Scottish Water. In developing measures and setting targets, we consider that Scottish Water should commit to the following principles:

- The measures should align with both the outcomes outlined in the Scottish Ministers' Objectives and the outcomes Scottish Water is expected to deliver as part of the water sector vision to help track progress towards achieving the water sector vision.
- The measures should allow Scottish Water to demonstrate its progress against its current commitments (e.g. Scottish Water's target to reduce operational emissions by at least 75% by 2030).[145]
- Scottish Water has a measure (or measures) covering asset condition, to allow stakeholders to understand the impact of maintenance activities on the asset base.
- Comparisons with performance over time should be retained, where appropriate (e.g. in relation to drinking water quality measures).

[145] Scottish Water (2020), *'Net Zero Emissions Routemap'*, 13 September 2020.

- Scottish Water should propose annual targets or commitments on the performance measures in its business plan, taking account of the investment programme proposed in the plan (recognising that this may change) and historic performance.
- The annual targets should be stretching while maintaining the incentive for outperformance.
- WICS and Scottish Water should assess performance against the measures set out in the Final Determination with any management or employee incentives aligning with these measures, notwithstanding that Scottish Water may track other measures (e.g. health and safety).

We consider that our requirement for a delivery plan and the annual refresh of the delivery plan could allow Scottish Water to reflect the impact of any changes in the investment baseline on its forecast performance on its levels of service measures.

15.4. Assessment of the proposed approach

Our assessment of the proposed approach takes account of two areas:
- the expectations of Scottish Ministers as set out in the Commissioning letter; and
- the extent to which they meet the proposed principles for SRC27 (see section 5.5).

Each area is examined in turn.

EXPECTATIONS OF SCOTTISH MINISTERS AS SET OUT IN THE COMMISSIONING LETTER

The Commissioning letter sets clear expectations that the Scottish Water must:
- make clear and demonstrable progress towards Ministerial Objectives and water industry vision; and
- continue to meet statutory obligations in responding to Net Zero and should ensure systematic monitoring and reduction of carbon emissions to ensure that reductions can be quantified.

We consider that our proposals are consistent with these expectations.

THE EXTENT TO WHICH THE PROPOSED APPROACH MEETS THE PROPOSED PRINCIPLES FOR SRC27

Table 18 provides our assessment of the proposed approach against the principles set out in section 5.5.

Table 18: Levels of service option assessment

Principle	Assessment
Evidence and analysis	Comparisons with other companies will enhance the evidence and analysis of the scope for improvements in performance.
Accountability	The proposed option will improve our understanding of Scottish Water's progress towards achieving the Ministerial Objectives and its contribution towards the sector vision. The business plan will also provide clarity on Scottish Water's annual targets or commitments over the regulatory period, enhancing the accountability of Scottish Water.
Flexibility	The proposed approach of setting level of service measures should provide Scottish Water flexibility over how it meets those measures (e.g. through non-traditional solutions such as nature-based solutions).

List of consultation questions

Chapters 1 to 4: Introduction, overview and scene setting

1. Do you have any views on chapters 1 to 4?

Chapter 5: Principles for the Strategic Review of Charges 2027-33

2. To what extent do you agree with the key principles outlined for SRC27?
3. Are there other relevant principles that should be considered? Why?

Chapter 6: Scottish Water's SRC27 submission

4. What further information could Scottish Water provide in its business plan?

Chapter 7: Establishing confidence in Scottish Water's plan

5. Which key elements of Scottish Water's business plan would benefit most from assurance? Why?

Chapter 8: Customer engagement

6. Do you support our proposed approach on customer engagement? Why?
7. Do you have any further views on chapter 8?

Chapter 9: Core and non-core activities

8. Do you have any views on our proposals to provide further clarity on the definition of core and non-core activities for the purposes of our regulation?

Chapter 10: Balancing costs between current and future customers

9. Do you have any views on our proposals in relation to balancing the costs between current and future customers?

Chapter 11: Form of control

10. Do you have any views on our proposed form of control?

Chapter 12: Cost assessment

11. Do you have any views on our proposals in relation to cost assessment?

Chapter 13: Operating expenditure

12. To what extent do you agree with the proposed approach to assessing Scottish Water's efficiency?
13. Do you have any further views on chapter 13?

Chapter 14: Investment

14. To what extent do you agree that our proposals provide the required level of flexibility for Scottish Water's investment programme, while ensuring that Scottish Water remains accountable for delivery?
15. Do you have any further views on chapter 14?

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