

Sir Jon Cunliffe

23 April 2025

Chair
The Independent Water Commission

Your Ref:
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Sent via email: cfe.water@defra.gov.uk

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Dear Jon

INDEPENDENT WATER COMMISSION CALL FOR EVIDENCE

Thank you for the opportunity to engage with the work of the Independent Water Commission in its important review of the delivery and regulation of water services in England and Wales.

While water is a devolved matter in Scotland and sits outside the scope of the Commission's review, we welcome the opportunity to share insights into the Scottish regulatory model and wider industry framework. It is a valuable opportunity to reflect on the shared challenges and opportunities that face the water sector in the UK and beyond.

Context and overview

Scotland's water industry operates within a clearly defined and well-established framework. At its core is Scottish Water, a publicly owned, commercially operated utility that is subject to independent economic, environmental and drinking water quality regulation.

As economic regulator we play a key role in ensuring that Scottish Water delivers for the people of Scotland. We do this by setting charge caps through the Strategic Review of Charges and holding Scottish Water to account for its performance and investment delivery. Our aim is to ensure that customers pay no more than is necessary for high-quality water and wastewater services, both now and in the future.

This regulatory framework has delivered clear benefits for customers. Water charges in Scotland remain among the lowest in the UK, and Scottish Water has invested more per person than any other UK water company since 2002. This sustained investment has contributed to improved service levels, Scottish Water is among the top-ranking companies in Scotland on customer service, as measured by the UK Customer Satisfaction Index (UKCSI), and it outperforms the average UKCSI for the water sector across the UK.

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We have recently published our final methodology for the Strategic Review of Charges 2027-33¹ which provides further information and context for our regulatory approach.

Scotland's regulatory model

We were pleased to be invited to participate in two dedicated sessions with the Commission's Secretariat, covering the Scottish water industry's structure, governance and regulatory approach (forthcoming session), and the functioning of the non-household retail market (session complete). We would be happy to continue this dialogue should the Commission wish to explore any area further.

Some key features of the Scottish model that may be of interest include:

- The roles and responsibilities across regulatory and delivery bodies, supporting accountability and collaboration;
- A Strategic Review of Charges underpinned by Ethical Business Practice and Regulation (EBP&R); and
- Public ownership with a focus on long-term thinking in investment.

These areas are covered in Appendix 1 to this letter.

- The structure and design of the non-household retail market; and
- A collaborative approach to engaging with licensed providers and other market participants, including a jointly developed Code of Practice.

These areas are covered in Appendix 2 to this letter.

There are challenges inherent in any regulatory framework—and we continue to evolve our approach in response. Many of the most pressing issues we face are shared: climate resilience, ageing infrastructure, public trust and affordability among them. We believe there is significant potential to share learning and develop best practices.

We welcome the Commission's commitment to considering a wide range of perspectives and practices, and we are grateful for the opportunity to contribute. We look forward to continuing the conversation and supporting the sector-wide dialogue on the future of water services.

Yours sincerely,



David Satti
Interim CEO

¹ Our final methodology for the Strategic Review of Charges 2027-33 is available at <https://wics.scot/publications/price-setting/strategic-review-charges-2027-33/approach/2027-33-final-methodology>.

Appendix 1: Scottish water industry structure, governance and regulatory approach

The roles and responsibilities across regulatory and delivery bodies, supporting accountability and collaboration

Scottish Water is responsible for providing water and wastewater (covering the removal of foul wastewater and surface water drainage) services to millions of households, which covers the majority of the population in Scotland. Scottish Water also acts as a wholesaler of these services to licensed providers in the non-household retail market, which was introduced in 2008.

The Scottish water industry involves several other organisations, each with their own roles and responsibilities.²

- 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 (we cover the latter in Appendix 2).
- 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.

² Additional information on the roles of the industry stakeholders is available online at: Scottish Government, '*Water industry governance*', webpage.

- The **Scottish Public Sector Ombudsman** (SPSO) acts as the final stage for handling customer complaints for public sector bodies and departments.
- The role of **licensed providers** will be covered in more detail in Appendix 2. However, at a high level, licensed providers are responsible for performing the retail functions for which they are licensed by providing retail services to non-household customers.
- The **Central Market Agency** (CMA) administers the retail market systems used by Scottish Water and licensed providers. This includes information regarding meter readings, transfer requests and the non-household customers registered to each licensed provider in Scotland. The CMA also calculates the wholesale charges that licensed providers owe Scottish Water.

Having clarity over these roles helps ensure that the industry works in partnership to understand the challenges and build consensus on the appropriate way forward.

WICS has the general function under Section 1(2) of the Water Industry (Scotland) Act 2002 (the **2002 Act**) of promoting the interest of (current and future) customers. The 2002 Act gives WICS three broad powers: the power to advise Scottish Ministers (s.3); the power to require information from Scottish Water (s.4); and the power to make charge determinations (ss.29B-29G).

We also publish annual performance reports, in line with our role to promote the interest of customers (s.1(2)).

A Strategic Review of Charges underpinned by Ethical Business Practice and Regulation

For the Strategic Review of Charges 2021-27 (SRC21), we recognised the need to adapt our regulatory approach to ensure Scottish Water is best placed to address the challenges facing the industry. Our approach for SRC21 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, reducing asymmetries of information. We consider candid discussions and sharing information essential to build a common understanding and consensus about the nature of challenges and how best to respond to them. Scottish Water must gain the confidence of WICS and other stakeholders by being transparent and producing compelling evidence to show how it is acting in the best interests of customers and the environment.

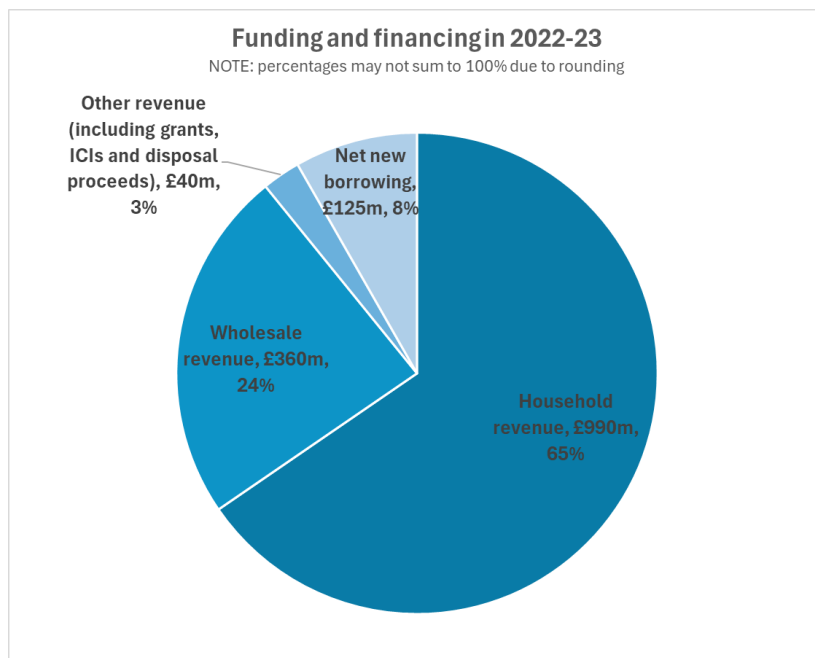
The move to a new regulatory approach based on the principles of EBP&R facilitated open and honest discussions about the long-term challenges the industry faces and how to address them. The step-change in levels of engagement and collaboration delivered significant benefits, including the development of a shared sector vision and the building of a greater awareness of the challenges associated with Scottish Water's ageing asset base.

Our expectation for SRC27 is that Scottish Water must have 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.

Public ownership with a focus on long-term thinking in investment

Given the delivery of water and removal of wastewater requires investment in infrastructure that lasts decades, in Scotland we have shifted towards examining funding requirements over the next six years in the context of the long-term challenges facing the industry. In SRC21, we recognised that investment would have to increase over time and, working closely with stakeholders, we decided to adopt a multi-period regulatory strategy of a gradual and smooth transition to much higher levels of investment. We consider that the overall regulatory framework underpinned by the principles of EBP&R has been key to enabling this long-term approach. Specifically, this framework involves Scottish Water as a publicly owned, commercially operated utility that is subject to independent economic, environmental and drinking water quality regulation.

To set charge caps, WICS forecasts the cash that Scottish Water requires to cover the efficient³ cost of Scottish Water providing water and wastewater services and delivering the investment priorities set out in Ministerial Objectives. Most of Scottish Water’s cash inflows come from customer charges and public borrowing, with a small additional inflow from other sources such as grants, contributions and infrastructure charges from developers.



³ An improvement in efficiency is defined as either a reduction in costs with no deterioration in service; or maintaining costs, while improving service.

Scottish Water then 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.

As Scottish Water is publicly owned, any cash surpluses it generates are reinvested in maintaining and improving services for Scottish customers.

Appendix 2 – non-household retail market

The structure and design of the non-household retail market

Overview

The Water Services etc. (Scotland) Act 2005 (the **2005 Act**) introduced a retail market in Scotland and, as a result of this, since April 2008, all non-household customers in Scotland have been able to choose a licensed provider regardless of the customer's size, location or level of consumption.

The non-household retail market in Scotland has now been operating effectively for over sixteen years. During this time, customers have enjoyed greater choice and tailored services, whilst licensed providers have developed enhanced services to meet the expectations of their customers, for example by offering a more responsive customer service, new methods of payment, automatic meter readers and advice on how to improve water efficiency or reduce discharges.

Our duties

WICS has the general function under Section 1(2) of the Water Industry (Scotland) Act 2002 (the **2002 Act**) of promoting the interest of (current and future) customers (the **Customer Function**). Section 11 of the 2005 Act provides that WICS has the duty to exercise its functions relating to retail services licences for the purpose of securing the participation by licensed providers in a) an orderly manner and b) in a manner that is not detrimental to the exercise of Scottish Waters' core functions (the **Participation Duty**).

As the regulator of the market, WICS also has responsibility for the administration of the retail licensing framework (and its associated codes and documents) and to monitor and enforce licensees' compliance with their licence obligations. Unlike Ofwat, WICS does not have an active remit to promote competition, nor does it have any concurrent competition powers. We do however ensure that the market arrangements support a level playing field and are compliant with competition law and state aid requirements.

Market structure

Under the 2005 Act, Scottish Water continues to operate and maintain Scotland's publicly owned water and wastewater network. Scottish Water cannot, however, provide retail services to non-household customers. Instead, non-household customers are required to contract with a licensed provider for the provision of those services.

Licensed providers compete in the retail market by purchasing wholesale services from Scottish Water at regulated wholesale prices (the **Scheme of Charges**) and providing retail services to their customers. The retail functions of licensed providers are limited to customer facing activities such as meter reading, billing arrangements, payment collection and bad debt management. Some

licensed providers also offer additional value-adding services such as advice on water efficiency and management of wastewater discharges.

Level playing field

The retail market was designed to be as transparent as possible and built on the basis of regulated rather than negotiated access. This approach supports a level playing field and ensures that any new entrants who obtain a water and/or sewerage services licence from WICS can access a standardised wholesale contract with Scottish Water (the Wholesale Services Agreement) without the need for further negotiation. The Wholesale Services Agreement was developed by WICS and any modifications or departures require its prior approval.

The codes governing the market are publicly available documents that all new entrants must sign. This enables the entire market to operate under the same set of rules. Market settlement, customer registration and switching are controlled by an independent company, the Central Market Agency (**CMA**), which is jointly owned by all market participants. The CMA also calculates the wholesale charges within the market to ensure a level playing field for all market participants.

Incumbent arrangements

One of our key aims when creating the retail market was to ensure that there would also be a level playing field between Scottish Water Business Stream (**SWBS**) and any new entrant. In light of this and SWBS's ownership structure, WICS issued the Water Services (Intra-Group Regulation) Directions to Scottish Water, under Section 11(2) of the 2005 Act, to put in place measures to ensure business separation between Scottish Water and SWBS. Scottish Water and SWBS were also required, through direction under Section 11 of the 2005 Act and SWBS's licence conditions respectively, to comply with a strict Governance Code.

Whilst many of SWBS' customers in Scotland have switched to other licensed providers since market opening, it still holds however an important share of the retail market (around half of the Scottish market, depending on whether you look at number of supply points or the proportion of wholesale charges). The Governance Code therefore continues to play an important role in building and maintaining confidence in a level playing field.

Wholesale prepayments and financial resilience

Consistent with our duty to ensure no detriment to the exercise of Scottish Water's core functions, all licensed providers are required to prepay wholesale charges to Scottish Water. The level of prepayment is determined by Scottish Water in line with its publicly available Financial Resilience Statement (**FRS**) that applies a uniform assessment of the financial strength and creditworthiness of licensed providers. The FRS was introduced by Scottish Water (and approved by WICS) following the implementation of a voluntary standard licence condition on financial resilience (**SLC B4**), which

has been accepted by all licensed providers. WICS introduced SLC B4 following the Covid-19 pandemic which highlighted the importance of ensuring that all licensed providers remain appropriately capitalised and can withstand similar external shocks.

Default Directions

Consistent with standard licence condition B1 (Duty to provide default services), each general licensed provider is bound by WICS' Default Directions. The Default Directions place a universal service obligation on all general licensed providers and require them to offer their customers (regardless of size, location or level of consumption) a set of default retail services to a particular standard (the **default standards**) and at a price not exceeding a maximum amount (the **default maximum tariffs**).

The default maximum tariffs are set annually by WICS and represent the prices which customers would have been charged if Scottish Water was still providing services directly. By doing this, WICS ensures there are no adverse financial effects for customers from the introduction of competition. On the contrary, licensed providers compete in the retail market by offering various levels of discounts against the default maximum tariffs. The Default Directions therefore not only act as a safety net but also allow most customers to benefit by paying less than the default maximum tariffs that would have applied if the retail market had not opened to competition.

Provider of Last Resort arrangements

The market framework has been designed to ensure that certain systems are in place to protect customers in the event of licensed provider failure. The combination of paying wholesale charges in advance to Scottish Water and the Provider of Last Resort (**PolR**) provisions within the market framework mean that Scottish Water is protected financially and customers are transferred automatically to new licensed providers should their chosen licensed provider exit the market in a disorderly manner. To achieve this, the Market Code contains mandatory arrangements whereby any licensed provider that exceeds a 20% market share (based on wholesale charges) is required to participate in the PolR process. The remaining licensed providers can opt out on an annual basis should they seek to do so.

A collaborative approach to engaging with licensed providers and other market participants, including a jointly developed Code of Practice

WICS wants to ensure that the market continues to deliver a wide range of benefits to customers and that customers can make informed choices on the service offerings from licensed providers. Ensuring that customers can access (and have confidence in) clear and transparent information about licensed providers' service commitments is critical to support and retain customers' trust and confidence in the market.

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On this basis, and consistent with our duty to promote the interests of customers, we have recently introduced a Code of Practice for the non-household retail market. The Code of Practice has been collaboratively developed by market stakeholders and introduced as part of a voluntary standard license condition B6 (Duty to comply with the Code of Practice), which has been accepted by eighteen licensed providers (representing circa 99.9% of the retail market on a supply point basis).

Equally, we have also introduced the Market Health Check that forms a key underpinning to the principles of Ethical Business Practice and improves customer outcomes by providing a mechanism to proactively determine whether licensed providers are upholding the service commitments set out in the Code of Practice, including their compliance with existing licence conditions. It provides an opportunity for licensed providers to monitor their performance against their commitments and address any identified issues for the ultimate benefit of customers.