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Scottish Water's Strategic Projections: A summary of our current thinking

Introduction

This is the first in a series of 2018 Decision Papers that the Water Industry Commission will publish for the Strategic Review of Charges 2021-27. The Commission published thirteen Initial Decision Papers during 2017. The Commission will issue a series of further Decision Papers throughout 2018. These papers will update customers and stakeholders on the Commission's latest views and decisions for the Strategic Review of Charges 2021-27.

The 2018 Decision Papers provide the Commission's views on:

- Strategic issues facing the industry that will impact levels of service beyond the next regulatory control period;
- The prospects for customers' charges during the next regulatory control period;
- Issues that directly and materially impact the charges that customers will pay in the next regulatory control period; and
- The potential for Scottish Water to engage even more effectively with its customers.

The clarity of the governance framework for the water industry in Scotland is a significant strength. The role of the Scottish Government as policy maker, owner and banker is well defined and recognised. The objectives and principles of charging set the boundaries for the Strategic Review of Charges. As such, discussion about approaches to asset replacement, planning and prioritisation of investment and compliance with European Union Directives takes place within the policy for the industry set out by the Scottish Ministers.

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review, taking account of all the evidence available to it in coming to the views set out in these Decision Papers. The final section of this paper sets out the framework for the key performance indicators that we will use to oversee the delivery of the changes to the regulatory framework.

In line with the Cooperation Agreement signed with Scottish Water and Citizens Advice Scotland, the Commission would be minded to adopt a Strategic Plan that is consistent with the Commission's Final Decision Papers and agreed with the Customer Forum as its Draft Determination.

This first 2018 Decision Paper sets out the Commission's views on Scottish Water's Strategic Projections which were published in February 2018, including the relative impact on prices of the various inputs to the Strategic Review of Charges 2021-27.

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The Commission's expectations

In its methodology for the Strategic Review of Charges 2021-27, the Commission set out its expectations for future proofing the water industry for customers. Scottish Water should:

1. Develop a clear strategy, maximise the opportunities available to it and provide clear evidence for its approach. Stakeholders will expect to be able to scrutinise the evidence provided.
2. Adopt behaviours that build trust and make progress in instilling pride among its customers and within the communities that it serves.
3. Ensure its asset management allows it to evidence the resources that it will need to improve its performance. Develop the asset information, which will underpin effective, efficient and timely replacement of its assets.
4. Improve its efficiency and, where appropriate, take advantage of innovation to ensure that prices are kept as low as is consistent with a sustainable industry for future generations.
5. Work collaboratively and constructively with regulators and other stakeholders to identify and implement the most effective and efficient solutions.
6. Improve the transparency and frequency of its reporting on performance.

The Commission considers that there are three key building blocks of this Strategic Review of Charges:

- *Evidencing the asset replacement challenge and developing an appropriate, efficient and effective response.* The Commission is working closely with Scottish Water and other stakeholders to establish an approach to long term asset replacement. It expects Scottish Water to develop a common understanding amongst its stakeholders of the resources that it will require in order that an appropriate transition to a sustainable level of annual investment can be put in place. Such a transition should be fair to both current and future generations. The Commission will set out its latest thinking on this issue in 2018 Decision Paper 5.
- *The introduction of a rigorous investment planning and prioritisation process:* Scottish Water will set out succinct, yet comprehensive investment appraisals that will allow stakeholders to provide an informed view on Scottish Water's proposals. Such appraisals should cover the impacts on, and views of, customers and communities. The Commission sets out its initial views in 2018 Decision Paper 3.
- *The process for evidencing financial, service level and water and environmental compliance in the coming regulatory period and beyond.* The Commission will set out its initial thinking on monitoring performance in 2018 Decision Paper 6.

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Overview

Scottish Water published its draft Strategic Projections in February 2018. The document sets out Scottish Water's long-term ambitions in areas such as customer experience, prices and sustainability of services.

The draft Strategic Projections reflect several of the themes set out in the Commission's methodology and its Initial Decision Papers. In particular, the Commission welcomes Scottish Water's ambition to take full ownership of its long-term strategy and work closely with customers, communities and stakeholders. However, there remains some way to go if Scottish Water is fully to deliver on these ambitions.

In its Strategic Projections, Scottish Water recognises the importance of taking steps to ensure prices remain broadly stable and as low as is consistent with ensuring that the industry meets the needs and expectations of both the current and future generations of customers. The Commission sees no benefit in lowering charges in one regulatory period if, in so doing, it would have to raise them more sharply in future. The Commission has also identified that, depending on the final prospects for prices, reprofiling charges at the end of the current regulatory period may contribute to a more stable longer-term profile.

This first 2018 Decision Paper provides more detail on the Commission's thinking following the publication of Scottish Water's draft Strategic Projections. In line with the principles of Ethically Based Regulation, the Commission has shared its thinking with, and sought input from, its stakeholders. The Commission will continue to gather views and refine its thinking. It will set out its further thoughts in future Decision Papers.

We have captured our current views in the following bullet points.

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The Commission's thinking as it began the Strategic Review of Charges 2021-27...

- The Commission asked Scottish Water to prepare Strategic Projections.
- The principles of the Methodology were that:
 - Scottish Water should “own” its strategy and relationship with customers and communities; and
 - The Commission adopts Ethical Based Regulation.
- Indications at the time suggested less borrowing might be available.
- The Commission considered that total investment over future regulatory control periods was likely to increase. The Commission expected capital maintenance to become an increasing proportion of total investment.
- The Commission could not rule out the necessity of a price increase above the rate of inflation, however, it also recognised the importance of maintaining a hard budget constraint on Scottish Water.
- The Commission identified scope to reduce any pressure on prices through smoothing price increases for customers: this would require the Commission to allow Scottish Water to increase revenue in equal annual percentage steps from 2019-20 to 2026-27.

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The Commission's joint working with stakeholders has allowed its thinking to advance both more quickly and more productively...

- There is currently no clear evidence that significant price increases are necessary in the next regulatory control period.
- Scottish Water still has to convince customers, communities and its other stakeholders that it could commit more capital expenditure efficiently and effectively in the next regulatory control period.
- The Commission continues to believe that investment will be higher in the future than in the past. Scottish Water's Strategic Projections highlight many of the challenges that the water industry faces.
- In the light of the Scottish Ministers' draft Objectives for the industry, the Commission does not see any benefit from lowering customers charges (relative to inflation) in the next regulatory control period when there is a very high likelihood that this would result in significant increases (above the rate of inflation) in the longer-term.
- Scottish Water could offer to hold a proportion of its allowed for investment in reserve and release it only when there was clear evidence of a need to spend and a capacity to commit resources effectively. Such an approach would ensure an appropriate hard budget constraint.
- Maintaining such a constraint requires the rigorous planning, prioritisation and appraisal of capital expenditure to ensure customers' money is spent as effectively as possible.
- An effective and responsive planning and prioritisation process will also help to manage future investment challenges facing the industry.
- Customers and communities must have a clear input to the planning and prioritisation of investment.

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The Commission is very pleased that Scottish Water and its stakeholders have engaged so regularly...

- The Commission's methodology identified the need to address some very complex issues such as capital maintenance and very long term investment planning.
- The Commission published its Initial Decision Papers during the Summer and Autumn of last year.
- Scottish Water published a draft of its Strategic Projections in February of this year.
- As such, the Commission and the other stakeholders are still developing a full understanding of the issues arising.
- The Commission and its stakeholders are asking a number of questions, such as:
 - Can customers and communities take pride in public ownership of Scottish Water? What ought Scottish Water to do to build such important social and natural capital?
 - Are Scottish Water's Strategic Projections sufficiently ambitious?
 - What are the timescales for delivery of required improvements to drinking water quality and the environment?
 - How can we achieve higher levels of transparency in the delivery of investment, particularly in relation to Capital Maintenance?
 - Are Scottish Water's asset management processes sufficiently robust?

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As the Commission is at an early stage of the Strategic Review of Charges, there are a number of outstanding questions...

- How will Ministers' Objectives develop through the consultation process and how will this impact on their ambitions for:
 - Future generations?
 - Rural Provision?
 - Lead?
 - Flooding?
- How will Ministers' Principles of Charging impact:
 - Levels of borrowing?
 - Household charging?
 - Developer contributions?
- How might the understanding of the timing, efficiency and effectiveness of Capital Maintenance develop?
- Will stakeholders be able to agree a comprehensive and inclusive investment planning and prioritisation process that ensures the delivery of Ministers' objectives?
- How will Scottish Water perform over the remainder of the regulatory control period?
- How might customers' views change over the next two or three years?
- How might the Commission's understanding of customer behaviours change – in particular what do customers expect from the industry over the long term?

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There is much to do. The principal next steps in the Strategic Review of Charges process include...

- Scottish Water has to take further steps towards taking full ownership of its strategy. Our methodology challenged Scottish Water to 'Seek trust, but expect verification'.
- Scottish Water's Strategic Projections are an important step forward. For example, it has adopted a more collaborative and positive approach to meeting future challenges.
- The Commission's focus as the economic regulator will need to be principally on agreeing the investment planning and prioritisation process and developing its understanding of Capital Maintenance.
- Scottish Water may sensibly offer to hold a proportion of its allowed for investment in reserve and release it only in line with an agreed process and when there is clear evidence of a need to spend and a capacity to commit resources effectively. In such a circumstance, it may be appropriate to consider a reprofiling of charges at the end of the current regulatory control period.
- The Commission outlines six key building blocks later in this decision paper. There is more to do. For example, Scottish Water will doubtless take further steps:
 - To define and communicate a strategy for the longer term;
 - To build trust with stakeholders;
 - To develop an enriched dialogue with customers and communities to augment social and natural capital; and
 - To set appropriate performance measures for the organisation, in line with the developments to the regulatory framework.

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Timetable for 2018 Decision Papers

The Commission sets out its current timetable for the publication of its 2018 Decision Papers in the following table.

2018 Decision Paper	Topic	Publication date
1	Scottish Water's Strategic Projections: A summary of our current thinking	25 July 2018
2	Assumptions on macroeconomic inputs and customer base growth	25 July 2018
3	Investment planning and prioritisation	25 July 2018
4	Meeting long-term investment needs	26 September 2018
5	Capital Maintenance	26 September 2018
6	Performance monitoring	21 November 2018
7	Financial tramlines	21 November 2018
8	Prospects for prices	21 November 2018

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Regulatory framework: Key Performance Indicators

Ethical Based Regulation requires a defined framework in which a regulated company is expected to operate. It offers clear benefits to a regulated company that meets and exceeds the expectations that underpin the framework. It envisions a more collaborative approach – not necessarily always working jointly on issues – that will take more informed and better evidenced decisions and build the trust and confidence of customers and communities. The Commission set out its expectations of such a 'paradigm shift' in its methodology for the current Strategic Review of Charges.

The Commission's framework for economic regulation seeks to ensure improved and sustainable outcomes for customers and communities. If it is working effectively, Scottish Water should be demonstrably making progress towards such improved outcomes.

The Commission is developing key performance indicators for monitoring, and reporting on, the revised framework for economic regulation. These indicators should apply during the current Strategic Review of Charges and in future regulatory control periods. They test whether the framework for economic regulation¹ is meeting the expectations of stakeholders and that we are making appropriate progress. Stakeholders are well positioned to gauge whether the framework is successful in allowing the industry to meet its longer-term challenges.

The performance indicators include a set of quantitative measures that should be linked to key delivery milestones within Scottish Water's work plans for the Strategic Review Process and for the 2021-27 regulatory control period. There are also a range of qualitative assessments that all stakeholders should address regularly. The aim of these regular assessments is to ensure that there is a useful common understanding of whether the regulatory framework is working for customers and communities. Doubtless, such assessments may also identify areas for improvement.

The Commission proposes to carry out an independent qualitative survey of all stakeholders throughout the period of the implementation of the new regulatory framework. The Commission will work jointly with OECD and stakeholders to define how best to take this process forward. After the Strategic Review of Charges, the Commission would seek to agree with the stakeholders how this regular qualitative survey is maintained and, when appropriate, enhanced. The views of customers and communities will be of particular importance in this regard.

The framework of the key performance indicators set out in the chart on page 11 reflects six key building blocks outlined in the methodology. They are centered around, and dependent upon, Scottish Water taking full ownership of its strategy.

The Commission considers that the answers to these questions will provide a useful and continuing perspective on the performance of the economic regulatory framework. It looks forward to discussing with stakeholders the most appropriate way to measure the quantitative assessments included.

¹ The Commission's expectations are set out in its methodology document, 'Innovation and Collaboration'.

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The Commission also recognises that the qualitative tests may be supported by some additional (and more detailed) questions. For example, it may be useful to track how stakeholders' expectations of the regulatory framework are changing at the same time as stakeholders' satisfaction with the outcomes of this framework are assessed. The Commission again looks forward to working with stakeholders to define the detail that underpins the high level qualitative assessments included in the chart.

Chart 1 – Framework for key performance indicators

