

**The Strategic Review  
of Charges 2015-21  
Draft Determination**

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## Chairman's foreword

I have pleasure in publishing the draft determination for the regulatory control period 2015-21 by the Water Industry Commission for Scotland (the Commission). This draft determination sets out the charges we propose to allow Scottish Water to levy on its customers. It also explains that we propose to freeze the maximum default tariffs that retailers can charge business and other non-household customers.

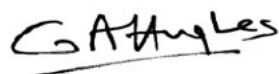
I would welcome any comments on our proposals by 12 June 2014. This will allow us to publish our final decisions on price limits in October 2014.

The process the Commission has followed in undertaking its Strategic Review of Charges for the new period has been considerably different from that followed in previous price reviews. The key innovations have been (a) the extensive involvement of the Customer Forum in representing the interests of all types of consumers, and (b) a strong encouragement to Scottish Water to produce a draft business plan that is consistent with ranges for the key financial and performance variables defined by the Commission.

The Commission acknowledges and applauds the efforts made by the Customer Forum and Scottish Water to agree on proposals that reflect customer priorities for improvements in the costs and levels of service. The draft determination will ensure that the increase in water charges over the period 2015-21 will be below the general rate of inflation while the investment programme will meet the requirements of the Scottish Government for improvements in water quality and environmental performance.

Notwithstanding the change in process, the draft determination requires that Scottish Water should continue to build on its substantial record over the last decade of improving its operating efficiency and the delivery of its investment programme. Adjusted for the agreed improvements in the level of customer service and environmental quality, the draft determination requires Scottish Water to reduce unit operating costs by about 2.2% per year and investment costs by up to 16%. If it is able to meet this challenge, Scottish Water will rank consistently among the top performers in the UK's water sector.

On behalf of the Commission, I would like to thank our staff very much for their hard work in providing the analytical support for our proposals.



**Gordon Hughes**

20 March 2014

# Executive summary

## Introduction

The Commission has a statutory duty to promote the interests of water and sewerage customers. We do this by determining the 'lowest reasonable overall cost' of meeting Ministers' environmental, quality and customer service objectives for the industry. The charges we set must also comply with ministerial principles of charging.

This document explains the proposed charges for the period 2015-21. We would welcome the views of stakeholders (which should be submitted by 12 June 2014). We will then publish our final determination in October.

## The proposed charge caps

At previous Strategic Reviews we have set household and non-household charge caps relative to the Retail Prices Index (RPI). At this review, however, in line with the Government's draft principles of charging, we are proposing to set charges relative to the Consumer Price Index (CPI).

For the purposes of comparison, we are also providing an indication of the charge cap that would have applied had we continued to use the RPI.

As in the 2009 Strategic Review, we have decided that the nominal increase in household customers' bills for each of the three years from 2015-16 to 2017-18 should be a fixed percentage increase. We also believe that it should be possible to maintain this profile of nominal charge increases for the remaining three years of the Strategic Review within the overall cap that we have set for the period.

The Commission proposes that the cap on household charges for 2015-21 should be as detailed in Table 1, while the cap on wholesale charges is given in Table 3. These charge caps take account of Scottish Water foregoing a further 1%<sup>1</sup> of a previously agreed increase in its charges for the financial year 2014-15.

The proposed charge caps mean that all household customers are likely to see their bills increase below the rate of inflation throughout the regulatory control period.

**Table 1: Household proposed charge caps**

	Total price cap from 2015-16 to 2020-21
Household customers (relative to CPI)	CPI – 1.8%

**Table 2: For comparison, household proposed charge caps relative to RPI**

	Total price cap from 2015-16 to 2020-21
Household customers (relative to RPI) for comparison purposes only	RPI – 6.3% <sup>2</sup>

**1**

Scottish Water had previously foregone agreed increases worth 5% on household bills.

**2**

The Commission has assumed a difference between inflation measured using the RPI and the CPI of 0.75% per year, or 4.5% over 6 years.

Our decision requires increases in actual household customers' bills to be no larger than 1.6% each year for the three years from 2015-16 to 2017-18. Our expectation is that this profile of increases will continue for the period 2018-19 to 2020-21. These annual increases in customers' bills are the same as the increase in 2014-15.

Our decisions regarding wholesale charge caps are broadly the same as for household customers. The only difference is that they are fixed annually relative to the CPI, not set in nominal terms.

**Table 3: Wholesale proposed charge caps**

	<b>Annual price cap from 2015-16 to 2020-21</b>
Wholesale customers (relative to CPI)	CPI – 0.3%

**Table 4: For comparison, proposed wholesale charge caps relative to RPI**

	<b>Annual price cap from 2015-16 to 2020-21</b>
Wholesale customers (relative to RPI) for comparison purposes only	RPI – 1.05%

We have also taken a related, although separate, decision about the default maximum retail tariffs that retailers can charge non-household customers. Our decision is to freeze default tariffs in nominal terms in each year of the regulatory control period. This decision would only be reviewed if there were to be a significant increase in inflation beyond the level currently targeted by the Bank of England.

**Table 5: Maximum increases to default tariffs levied by licensed retail suppliers**

	<b>Annual change from 2015-16 to 2020-21</b>
Water	0%
Wastewater	0%
Trade effluent	0%

This freeze in nominal default tariffs for the regulatory control period is the same as the Commission's decision for 2014-15.

# The Strategic Review of Charges: Summary of benefits

## Customers involved throughout the price-setting process

The Customer Forum has played an important role in representing customers at this review.

Scottish Water has taken full ownership of its decisions, both in its planning and in its delivery of that plan for customers.

The proposals set out in this document are consistent with the Minute of Agreement reached through engagement between Scottish Water and the Customer Forum.

## Benefits for household customers in Scotland

Our proposed charge caps would mean that all household customers' bills will increase below the rate of inflation throughout the regulatory control period.

At the same time, the charge caps will enable Scottish Water to improve our environment, its public health compliance and customer service.

## Benefits for non-household customers in Scotland

There would be no increase in the maximum charges payable by a non-household customer unless there is a substantial increase in inflation.

Non-household customers can benefit by switching supplier (see [www.scotlandontap.gov.uk](http://www.scotlandontap.gov.uk)).

Wholesale customers will also see their charges increase below the rate of inflation throughout the regulatory period.

## Benefits to the environment and to drinking water quality

The draft determination funds an investment programme of around £500 million a year (before inflation), allowing for the delivery of all of the Scottish Government's objectives for environmental and drinking water quality improvements, and including:

- continuing a major programme of work to address the pressing problems of Glasgow's drainage; and
- taking steps to improve the resilience of water supply systems across Scotland under extreme events.

## Benefits for rural communities

Scottish Water will work with the quality regulators to develop sustainable and cost-effective solutions for improving water and sewerage provision in rural areas.

## Supporting innovation

We have encouraged Scottish Water to seek out opportunities for alternative and/or more innovative investment options, where these would benefit customers or the environment. The company has responded well to this challenge – for example it has come up with a range of innovative solutions at water and waste treatment works and is continuing to develop its approaches to sustainable land management.

A number of regulatory innovations have been implemented at this review, including the use of financial tramlines and the establishment of the Customer Forum. We are already beginning to see the benefits for customers of this more innovative approach.

## 1

# The regulatory framework

**As the economic regulator, the Commission is one part of the wider regulatory framework that governs the water and sewerage industry in Scotland<sup>3</sup>. In particular, the Strategic Review takes place within a clearly defined policy framework set by the Scottish Government – specifically on the social, environmental and public health outcomes to be achieved and the principles that should underpin the setting of water and sewerage charges in Scotland.**

**In addition to the Scottish Government, a number of other stakeholders play an important part in the process. Their roles and responsibilities are summarised below.**

## The Scottish Ministers

The Scottish Ministers set the overall context for the Strategic Review, and are responsible for the policy framework governing the water and sewerage industry.

Scottish Ministers set the frequency and timetable for each Strategic Review, and determine the high-level environmental, quality and customer service objectives that Scottish Water must deliver through the 'Quality and Standards' process. The commissioning letter for the current Strategic Review is reproduced as Appendix 1.

Scottish Ministers also:

- set out the charging principles that should be followed in deciding the tariffs paid by customer groups for specific services;
- determine whether or not cross-subsidies should exist between groups of customers (and, if so, at what level); and
- identify the amount of borrowing that will be made available to the industry.

The role the Scottish Government plays in setting policy for the industry and water environment means there is no doubt about what each stakeholder must achieve.

## Scottish Water

Scottish Water is a publicly-owned business, answerable through the Scottish Ministers to the Scottish Parliament and to the people of Scotland. It provides water and wastewater services to household customers across Scotland and operates the network of pipes, water sources and treatment works. Scottish Water also acts as the wholesaler of water and wastewater services in the competitive market for businesses, public sector bodies, and charitable and not-for-profit organisations.

**3**

**The governance framework for the water and sewerage industry in Scotland was established by the Water Services etc. (Scotland) Act 2005.**

## The Commission

The Commission is the statutory body for economic regulation of the Scottish water and sewerage industry. It has a statutory duty to promote the interests of customers.

It does this by setting prices for water and sewerage services that deliver Ministers' quality, environmental and customer service objectives for the water industry at the lowest reasonable overall cost. The Commission's decision on the lowest reasonable overall cost for Scottish Water to deliver the ministerial objectives must be consistent with the principles of charging.

The Commission also facilitates competition in the Scottish water industry; in so doing, however, it must ensure that no detriment is done to Scottish Water's core business.

## The Customer Forum

The Customer Forum was established in November 2011 by a cooperation agreement between Scottish Water, the Commission and Consumer Focus Scotland (now part of Consumer Futures). The cooperation agreement is reproduced as Appendix 2.

Subsequent to this agreement the Commission wrote to the Chairman of the Forum to provide more information about its role and outlining the issues on which it should focus during the Strategic Review. The letter is reproduced as Appendix 3.

The Customer Forum has played a specific role by:

- working with Scottish Water on a programme of quantitative and qualitative research to establish customers' priorities for service level improvements and expectations in terms of the level of charges;
- understanding and representing to the Commission and to Scottish Water the priorities and preferences of customers (as a whole) in the Strategic Review process as identified through customer research; and
- seeking to secure the most appropriate outcome for customers (as a whole) based on those priorities and preferences.

## The Scottish Environment Protection Agency (SEPA)

SEPA is a non-departmental public body, accountable through Scottish Ministers to the Scottish Parliament. SEPA's role is to protect the environment and human health, to ensure that natural resources and services are used as sustainably as possible, and to contribute to the ministerial goal of sustainable economic growth.

As the statutory environmental regulator, SEPA works with the Scottish Government and Scottish Water to establish the requirement for future investment in the water industry to meet environmental standards. It also works with other industry stakeholders to monitor Scottish Water's delivery of the objectives set by Ministers, as well as carrying out day-to-day monitoring of Scottish Water's activities (such as discharges to both groundwater and surface water, and water abstractions).



## **The Drinking Water Quality Regulator (DWQR)**

The DWQR is the statutory regulator for drinking water quality in Scotland, providing an independent check that Scottish Water is complying with the legal standards for drinking water, as set out in regulations.

The DWQR has extensive powers to acquire information, conduct investigations and take enforcement action should this prove necessary. It also works with the Scottish Government and Scottish Water to establish the requirement for future investment in the water industry to meet current and future drinking water standards. It works with other industry stakeholders to monitor Scottish Water's delivery of the ministerial objectives.

In the Strategic Review process, both the DWQR and SEPA have an important role in working with Scottish Water, the Customer Forum and the Commission to define the work that is required to achieve the ministerial objectives.

## **Consumer Futures**

Consumer Futures (formerly Consumer Focus Scotland) is the advocate for water consumers in Scotland. Consumer Futures has a range of statutory powers and duties to enable it to act on behalf of consumers. This means a number of organisations (including Scottish Ministers, the Commission, Scottish Water, the DWQR and SEPA) must consult with Consumer Futures and consider its representations on behalf of consumers on water issues. In addition to its representative function, Consumer Futures has research and information functions relating to consumer matters, and has powers of investigation for certain categories of complaint.

When setting charges, the Commission must consult Consumer Futures and have regard to any representations it makes.

Consumer Futures becomes part of the Citizens Advice service on 1 April 2014.

## **The Outputs Monitoring Group**

Scottish Water's performance in delivering outputs is monitored by the Outputs Monitoring Group. This comprises representatives from the Scottish Government, Scottish Water, SEPA, the DWQR, Consumer Futures and the Commission. The group increases transparency for customers and stakeholders and ensures that Scottish Water is accountable for delivering the required outputs.

The group meets every three months to review progress against ministerial objectives (which are set out in an agreed programme of works) and against interim milestones for output delivery (set out in Scottish Water's agreed delivery plan). The group also oversees the process by which changes are made to the programme as a result of better information or revised priorities.

## 2

## How the Commission set charges

### Overview of the approach at this Strategic Review

We started planning for the Strategic Review shortly after the end of the last review in 2009. Through a project called 'Incentives, innovation and involvement' we identified a number of developments we wanted to make to the regulatory framework. Our aim was to ensure that Scottish Water is equipped for the challenges of the future and continues to provide high-quality water and sewerage services at the lowest reasonable overall cost.

We outlined our approach in detail in a methodology document, 'Strategic Review of Charges 2015-21: Innovation and choice' (May 2013). A summary version of the methodology was agreed with Scottish Water's Board in spring 2011.

Our revised approach is innovative and is more transparent than at previous reviews. The Commission has made clear decisions about the key inputs to the price review and the resulting prospects for prices. Scottish Water has taken full responsibility for the sustainable management of its assets and its relationship with its customers. Customers have been fully engaged in the process.

### How the Commission determined charges

There were eight main stages in developing this draft determination.

- The Commission published a series of notes setting out its views on how the next regulatory control period could turn out. These inputs included areas such as levels of cash expenditure, expectations for future efficiency savings, expectations for levels of service, and the financial tramlines<sup>4</sup>.
- We asked Scottish Water to write a strategic vision for the next 25 years. Its business plan for the next regulatory control period (2015-21) was to be fully consistent with this vision.
- We concluded a cooperation agreement with Consumer Focus Scotland and Scottish Water through which an independent Customer Forum was established. The role of the Customer Forum was to identify customer priorities and to secure the best outcome for customers within the ranges for the key inputs to a price review determined by the Commission. In establishing these ranges the Commission took full account of the draft ministerial objectives and the principles of charging.
- Scottish Water and the Customer Forum<sup>5</sup> conducted quantitative and qualitative research on customer service priorities, affordability and customer expectations for the future.
- Scottish Water wrote a series of Strategic Investment Reports (SIRs) covering all areas of its activity. The Commission commented on these, indicating where it agreed and where it considered more detail was required.

4

An innovative approach that allows all stakeholders to have confidence that Scottish Water's financial performance is consistent with its price determination and that the industry is in a financially sustainable position for the longer term.

5

Originally with Consumer Focus, before the Customer Forum was fully established.

- Scottish Water completed its business plan and the Commission commented on this in detail. The Commission determined the ranges it expected the Customer Forum to keep within when reaching agreement on service improvements with Scottish Water. These decisions included:
  - the appropriate levels of operating costs;
  - inflation rates for costs;
  - the financial parameters used in the tramlines;
  - the size of the capital programme;
  - the level of capital maintenance;
  - assumptions on growth; and
  - maintaining a benchmark with the OPA.
- The Customer Forum reached an agreement with Scottish Water. In a letter to the Commission, dated 30 January 2014, the Chairman of the Customer Forum summarises his assessment of the Customer Forum’s participation in the Strategic Review as follows:

*“I believe the process that the Commission established for this price review, with the active support of the Scottish Government and other key stakeholders, has given rise to a considerable empowerment of customer interests at the heart of the price setting process.”*

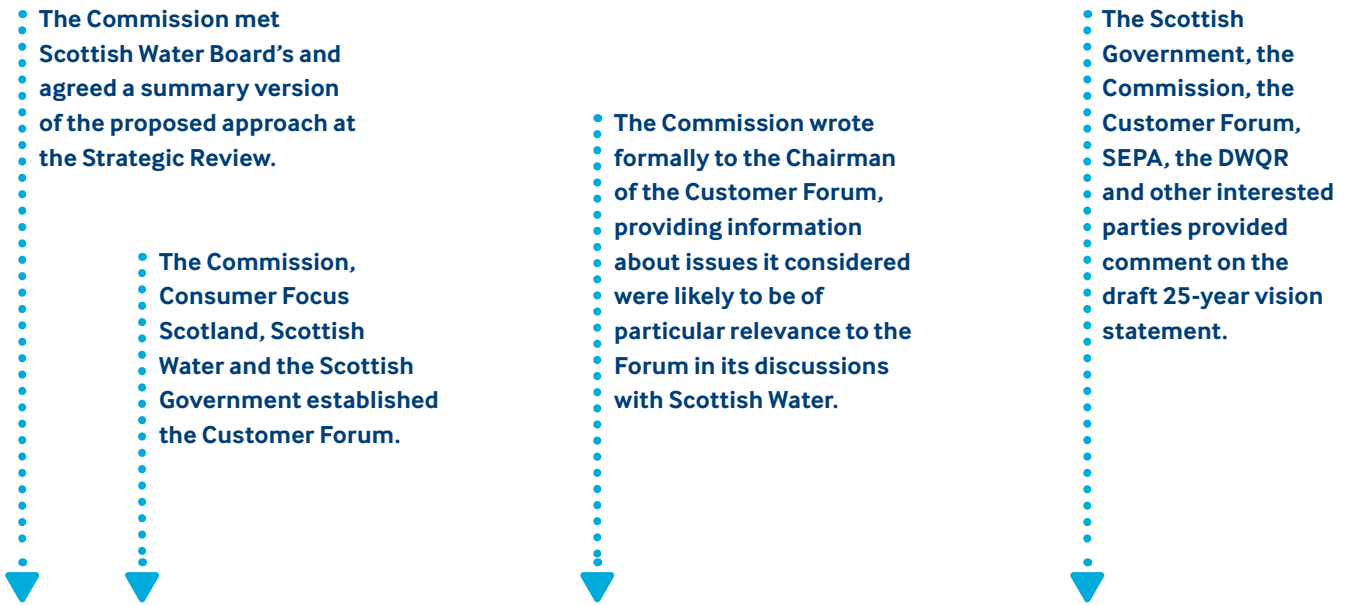
The final outcome of the discussions between Scottish Water and the Customer Forum is the Minute of Agreement that documents a set of agreed modifications to Scottish Water’s draft business plan. This is reproduced in full as Appendix 5.

- The Commission considered the modifications to Scottish Water’s draft business plan agreed by Scottish Water and the Customer Forum in the light of its decisions on the ranges for key parameters and reached a final decision on its draft determination.

The Commission’s decisions are considered in more detail in the following chapters.

### Timeline of the Strategic Review process

The following table summarises the timeline so far and the next steps.



Spring 2011

September 2011

June 2012

June – September 2012

October 2012

October – November 2012

November 2012

February 2013

October 2013

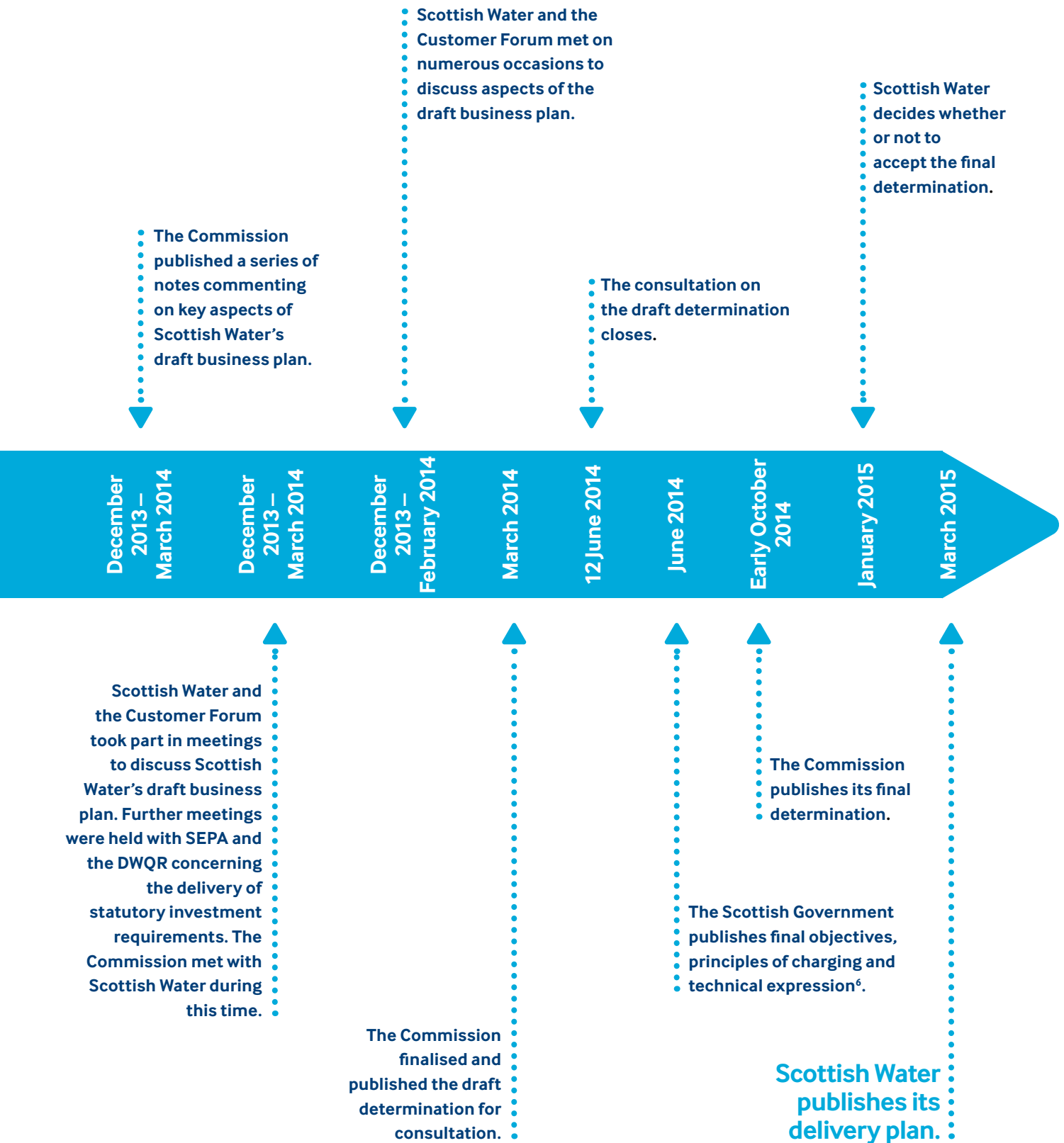
The Scottish Government provided the Commission with its 'commissioning letter'. This set out the broad arrangements the Government wished us to follow for the review, as well as a number of specific requirements Ministers expected should be met.

The Scottish Government issued its draft principles of charging and objectives.

The Commission provided its preliminary views on the key regulatory parameters, which together constitute the 'lowest overall cost' of meeting ministerial objectives.

Scottish Water published its draft 25-year vision statement.

Scottish Water published its final strategic vision and draft business plan.



6

This is the full list of projects that Scottish Water must deliver to realise the outcomes of Scottish Ministers' objectives.

## 3

## The key regulatory inputs: The Commission's initial views

### Introduction

This chapter explains our initial expectations, as outlined in notes we published between summer and autumn 2012. These notes set out the Commission's initial views on what could be possible in relation to:

- operating expenditure;
- levels of service measurement;
- levels of service performance;
- improving services in times of constrained borrowing;
- efficient use of capital investment expenditure;
- sustainable funding by customers;
- financial tramlines; and
- initial prospects for prices.

Each of these issues is considered in turn below.

### Operating expenditure

Commission Note 1 explained that the water industry had faced upward cost pressures over the past decade, and that operating expenditure in England and Wales had increased in real terms. In Scotland, by contrast, operating expenditure had fallen by around 40% in real terms, closing what had been a large efficiency gap.

At the last price review Scottish Water agreed to accept our challenge to match 2007 upper quartile performance of the industry in England and Wales before 2015. Scottish Water is on track to meet this challenge, and we believe that its operating expenditure performance is now broadly on a par with that of the leading companies. This does not mean, however, that it is equally efficient.

When we looked beyond 2015 we identified that upward pressures on costs were likely to continue, driven in part by rising compliance standards and growth in the customer base. We considered that these pressures could be significantly offset by continuing efficiency improvements.

On this basis we considered that a range for annual operating expenditure of between £320 million and £345 million (in 2011-12 prices) should be expected for the period 2015-20. This compares with £325 million in 2011-12, adjusted for one-off items. This was before any additional improvements in customer service were taken into account.

The comments that we made at that time (Summer 2012) on the prospects for operating expenditure did not take account of the extent to which Scottish Water chooses to implement operating cost solutions. We explained that the Commission's focus would be on total cash outlay, not operating expenditure alone.

### **Level of service measurement**

Commission Note 2 provided an outline of our framework for measuring Scottish Water's levels of service performance, and set out our initial views on how this framework could be improved for the forthcoming regulatory control period.

The Overall Performance Assessment (OPA) was originally developed by Ofwat in the late 1990s to compare the customer service performance of the companies in England and Wales. It has been beneficial to date to use the same performance assessment framework as is used in England and Wales, allowing direct comparisons of Scottish Water's performance against that of the companies south of the border.

Our note explained that Ofwat no longer collected the data for calculating companies' OPA scores. It would therefore not be possible for the Commission to benchmark performance against that of the companies in England and Wales.

Despite Ofwat's decision to retire the OPA framework, we considered that there could still be significant benefits from using a similar framework, provided it objectively measured Scottish Water's performance and reflected the priorities of Scottish customers. We cited a number of ways in which the current framework could evolve to achieve this.

### **Levels of service performance**

Commission Note 3 explained that Scottish Water's level of service performance had improved considerably since 2002 and that the company had narrowed the substantial gap in performance with the companies south of the border. We noted that Scottish Water was on track to achieve the challenge we had set at the previous price review, which was to match upper quartile performance of the industry<sup>7</sup> before 2015. To do so Scottish Water was required to achieve a score of between 380 and 400 points on the Commission's OPA index.

We also explained that we considered there was still significant scope for Scottish Water to improve, and that we expected the company to continue delivering improvements in customer service performance. We invited the Customer Forum and Scottish Water to reach agreement on the levels of service that might be achieved during the forthcoming regulatory control period. To inform their discussion we set out our initial views on what might be achievable.

At the time that we set that challenge, the threshold of 380 points was significantly higher than the median score across the companies of 373. By 2012 the median had increased to around 380 points. We commented that the lower threshold for Scottish Water should also be raised in response – our initial view being that there was scope to increase the lower threshold to 385 points.

In relation to the upper threshold, we noted that little had changed in England and Wales and explained that our analysis indicated that a target score of 400 was likely to be a challenging upper threshold.

Our note also explained how, occasionally, events wholly or partially beyond a company's control have an impact on performance measures, resulting in adverse effects on the OPA score. We suggested that this should be taken into account when reviewing performance across a full price review period and when agreeing future performance targets.

### **Improving services in a time of constrained borrowing**

Commission Note 4 explained that the average amount of borrowing available to Scottish Water from the Scottish Government in 2010-15 had fallen from £140 million a year to around £85 million a year. It also noted that borrowing over the next period, 2015-20, would be no more than £120 million a year.

The reduced borrowing in 2010-15 had not impacted customers directly because Scottish Water had offset the shortfall in borrowing by using the cash surplus it had generated through its outperformance over the period. The Commission noted though that any further reductions in borrowing from 2015 could be detrimental to customers.

The note explained that, for this reason, the Commission had decided to regulate and monitor Scottish Water on a total cash expenditure basis – increasing the transparency of the borrowing made available by Government. We also stated that the company should seek out opportunities to generate additional cash from within the business, and in particular to look for innovative solutions that would allow improvements to be delivered with less initial cash outlay than through more traditional engineering approaches. We recognised that moving away from traditional approaches would be a gradual process, but that it should be sustained year on year.

### **Efficient use of capital expenditure**

Commission Note 5 set out our expectation that Scottish Water's current level of capital investment looked set to remain broadly constant for the foreseeable future. This was based on the assumption that improvements in drinking water quality, environmental performance and services to customers would continue at the current pace.

We endorsed the Scottish Government's view that a level of capital investment of between £450 million and £500 million a year<sup>8</sup> was likely to be most efficient.

We explained that there was strong evidence that Scottish Water had improved both its cost efficiency and delivery of capital investment over previous regulatory control periods. Equally, we considered that Scottish Water should be able to improve its investment performance through a more strategic approach, and by adopting more innovative solutions, as well as smarter procurement and delivery.

We considered that these gains would allow Scottish Water to deliver both better value for money for customers plus improvements in water quality, environmental performance and customer service. That said, however, we noted that the scope for achieving higher levels of efficiency in capital expenditure might be less than in the past.

### **Sustainable funding by customers**

Commission Note 6 set out the Commission's views on the areas where there would be scope for engagement between the Customer Forum and Scottish Water. These were the extent of discretionary service improvements that Scottish Water could make, and the approach that could be used, or the timing, of some of the statutory improvements that Scottish Water had to deliver. We made it clear that, in the latter case, there would only be room for manoeuvre in specific circumstances.



This note also explained the regulatory framework (as is outlined in Chapter 1).

### The financial tramlines

Commission Note 7 provided more detail about a key element of our new regulatory approach, namely the financial tramlines. The Commission had worked with Scottish Water and the Scottish Government to develop and agree this mechanism, which would be used to monitor Scottish Water's financial performance and to ensure that the company could maintain an appropriate level of financial strength over the medium to long term.

The approach enables customers to benefit as quickly as possible when Scottish Water finds alternative ways to deliver the required improvements. Similarly, below a particular level, Scottish Water's management is required to explain, in a delivery plan, how and when performance would improve (this may involve, if the conditions warranted it, an 'interim determination of charges').

The note explained that the financial tramlines would be derived from cash-based financial ratios. It also set out the measures of financial strength and the values that the Commission had provisionally agreed with Scottish Water at that time. The ratios are set out in the table below. These ratios are all used by credit rating agencies as indicators of financial health, although the specific calculation of the ratios often varies between agencies<sup>9</sup>.

**Table 6: Targeted financial ratios by the end of this regulatory control period<sup>10</sup>**

Line	Cash interest cover II	Ratio of funds flow from operations to debt	Gearing
Upper limit	2.20	13.0%	50%
Discussion line	2.05	12.4%	
Middle line	1.90	11.75%	
Warning line	1.75	11.1%	
Lower limit	1.60	10.5%	55%

Our comparison of Scottish Water's financial strength with these ratios takes account of the fact that Scottish Water does not have access to index-linked debt.

**9**

In the document 'Strategic Review of Charges 2015-21: Innovation and choice' we stated that we intended to focus primarily on adjusted interest cover and gearing. We will continue to monitor the ratio of funds from operations to debt as a secondary indicator. We have focused on the adjusted interest cover ratio, which appears to attract more immediate attention from commentators. It is a better measure of financial sustainability if maintenance charges continue to increase in future.

**10**

Assuming index-linked debt, had it been available, would have represented 30% of total debt outstanding.

The note provided detailed information about the financial tramlines. In summary:

- If the company outperforms its regulatory settlement, its financial strength would increase towards the discussion line. It would be free to retain the savings that it generates while its financial strength lies between the middle line and the discussion line.
- If it underperforms but its financial strength remains above the warning line, then no action would be taken.
- If its financial strength reaches the discussion line, and is forecast to remain above this for the remainder of the price control period, the company would begin discussions with its customers and the Scottish Government about how the outperformance should be used.
- If its financial strength reaches the upper limit, and is forecast to remain there for the remainder of the price control period, the company would use the proceeds of outperformance over that limit to the benefit of customers. At this point, the outperformance would automatically be shared with customers. We said that the formula for determining the proportion of any outperformance to be shared with customers should be agreed at the start of the price control period.
- In the event that performance declines rather than improves, Scottish Water's financial strength would decrease towards the warning line. The purpose of the warning line is to provide an early signal that financial performance has declined.
- In the event that the lower line is breached, the Commission would review Scottish Water's performance and take appropriate action to ensure that the company is in an appropriate financial position in future. Such a response might entail, for example, recommending to Government that there be a reduction in the capital investment programme, an increase in customer charges or potentially, in exceptional circumstances, a revision to the position of the financial tramlines.

Under these proposals, Scottish Water would have had to breach both primary financial ratios for the responses outlined above to be triggered.

The Commission explained that it hoped that the Customer Forum would provide input to the discussions as to how and when benefit from outperformance by Scottish Water should be used.

### **Prospects for customers' charges**

Commission Note 8 set out, for the first time at such an early point in the regulatory process, the Commission's initial view on the prospects for customers' charges. This was based on our analysis of Scottish Water's performance and our assessment of future pressures and potential efficiencies and improvements.

We explained our view that maintaining Scottish Water's future investment programme within the ranges proposed by Ministers – while also maintaining its financial strength – would be likely to require prices that were close to current levels, in real terms. This was possible despite the probability that borrowing would be more limited than in the past.

We indicated the combinations of annual charge increases and levels of borrowing that would result in both levels of investment and levels of financial strength that were within the broad ranges indicated by Ministers (based on our initial analysis in this area). We used the RPI in our analysis.

As indicated in the figure below, amber shading shows borderline combinations where the limiting factors may, or may not, be achieved.

Red areas are as follows:

- upper left: there is a risk that the financial ratios that determine financial strength will be too weak, suggesting insufficient finance in the longer term and unstable charges;
- lower right: there is a risk that the financial ratios will too strong, suggesting that today's customers are paying too much;
- upper right: there is a risk that annual investment will be more than £500 million, which is beyond the Ministers' preferred range and may impact on the efficiency of delivery; and
- lower left: there is a risk that annual investment will be less than £450 million, which is below the Ministers' preferred range and may be insufficient to maintain and improve service.

The area between the lines is consistent with the borrowing expected to be available during this regulatory control period.

**Figure 1: Provisional assessment of borrowing and annual charge cap combinations**

		Annual charge increase 2015-21, relative to inflation							
Annual borrowing 2015-21		-1.25%	-1%	-0.75%	-0.5%	-0.25%	0	+0.25%	+0.5%
£140m		Red	Red	Red	Amber	Amber	Red	Red	Red
£120m	Expected annual borrowing	Red	Red	Amber	Green	Green	Green	Amber	Red
£100m		Red	Amber	Amber	Green	Green	Green	Amber	Red
£80m		Red	Red	Amber	Amber	Green	Amber	Amber	Red
£60m		Red	Red	Red	Red	Red	Amber	Red	Red
£40m		Red	Red	Red	Red	Red	Red	Red	Red

The preliminary assessment suggested that Scottish Water should be able to propose improvements in service and in efficiency such that prices and borrowing fall within the combinations shaded green or amber in this figure and maintain appropriate financial strength.

## 4

## The key regulatory inputs: Responding to Scottish Water's Strategic Investment Reports and further Commission guidance

### Introduction

The second round of commentaries and indicative decisions taken by the Commission were published in the summer of 2013. These notes reflected the Commission's views of the SIRs that Scottish Water had prepared to brief the Customer Forum, as well as our developing thinking in relation to a number of the key regulatory inputs.

The notes covered the following areas:

- overall service performance;
- maintaining base service;
- measuring levels of service performance;
- measuring customer satisfaction;
- mandatory water quality and environmental improvements; and
- meeting demand from new customers.

### Overall service performance

In Commission Note 9 the Commission outlined how the Forum could play an important role in bringing greater clarity about which aspects of service performance are given greater or lesser priority by customers.

The note outlined how the assessment could be used to create a regulatory contract for the period 2015-21. In particular, we stated our view that any measure of service performance should be not only relevant to customers but also reported in a transparent and consistent way.

Although the OPA is no longer reported in England and Wales, it could still be measured. We expressed the view that this should continue to happen as it would allow performance to be assessed on a like-for-like basis through time, so retaining management focus.

We commented that the Customer Forum could usefully consider how the existing OPA might be supplemented by one or more indicators, focusing on aspects of service performance not incorporated in the OPA. These could also form part of the regulatory contract with Scottish Water.

### Maintaining base service

Commission Note 10 was the Commission's response to the SIR on capital maintenance.

Scottish Water's report indicated that customers did not wish to see a reduction in any area of the base service and that, of this service, drinking water quality was considered to be the highest priority.

Scottish Water's SIR provided an overview of capital maintenance investment levels since 2002. The company also stated that there had been an underlying increase in capital maintenance activity over the past 10 years, once efficiency improvements were taken into account. This higher level of capital maintenance had contributed to the impact of higher standards of service (both in terms of drinking water quality and environmental performance).

The report indicated that significant increases in capital maintenance would be required in the 2015-21 period in order to maintain the improvements in service, drinking water quality and environmental performance that had been delivered during the current (2010-15) period. Scottish Water further stated that on-going efficiency improvements would only partially off-set further increases in future.

Scottish Water proposed that to maintain stable service levels in the next regulatory control period would require investment of around £270 million to £300 million a year.

The note concluded that Scottish Water's claim for an increase in capital maintenance was justified but that it should be tied to improved service levels to customers and improved operational performance.

We suggested that in its discussions with Scottish Water the Customer Forum might reasonably address:

- the profile for the additional expenditure on capital maintenance and how Scottish Water would report progress with respect to the delivery of this expenditure;
- the additional improvements in customer service that would be delivered as a result of increased spending on maintenance; and
- targets for the new Asset Health Indicator<sup>11</sup>.

### Measuring levels of service performance

Commission Note 11 outlined how levels of service performance might be measured. It reviewed how the Commission has used the OPA to monitor Scottish Water's service performance. Scottish Water has significantly improved its OPA performance in recent years and it is important that the higher level of performance should be maintained.

It would also be appropriate to consider a broader set of measures than those incorporated in the OPA, given that Scottish Water had closed the gap in its levels of service performance relative to the companies in England and Wales. If the Customer Forum identified further areas of service performance as being priorities for customers, then progress in these areas should be measured. Scottish Water's long-term ambition to become "Scotland's most valued and trusted business" could be encouraged by an additional measure that captured levels of customer satisfaction (this is considered further, below).

The note concluded that it would be appropriate to adopt a three-pillar approach based on:

- retaining the OPA in its entirety;
- measuring customer satisfaction and benchmarking Scottish Water's performance against its peers and comparator sectors; and
- introducing new service performance measures for areas identified as being customer priorities.

#### 11

**This is a new measure of asset performance and condition that is being developed by Scottish Water in consultation with the Commission. It will ensure that Scottish Water's asset base is being maintained appropriately in the interests of future customers.**

## Measuring customer satisfaction

In Commission Note 12 the Commission outlined its views on the introduction of the new measure of customer satisfaction. The success of the Service Incentive Mechanism (SIM) in England suggested that adopting a similar measure in Scotland could bring benefits for customers.

For Scottish Water to achieve its ambitions, it would need to establish what it needed to do to narrow the perceived gap in performance between its own performance and that of the most trusted and valued businesses.

There were three potential categories of businesses against which Scottish Water's performance might be compared:

- the broad utility/government sector;
- respected household brands such as Tesco, Sainsbury's and the Nationwide; and
- those 'best in class' companies such as John Lewis and Harvey Nichols that are generally recognised as offering the highest levels of customer service and satisfaction.

We concluded that it would be reasonable to expect Scottish Water, by the end of the next regulatory control period, to be among the very best in the first group, broadly comparable with the second group, and have narrowed some of the gap with the final category.

The SIM would represent a useful baseline for measuring customer satisfaction. The Customer Forum could agree priorities for measurement by March 2014. Performance and trends would be measured over the last year of the current regulatory control period and through the next regulatory period. Scottish Water should be able to achieve upper quartile performance by 2021.

## Mandatory water quality and environmental improvement investment programme

In Commission Note 13 the Commission summarised the main points and proposals in Scottish Water's SIRs on the future capital investment required to meet mandatory drinking water and environmental quality obligations.

In its SIRs Scottish Water provided a thorough review of:

- the legislative drivers of current and future investment, in particular the obligations that are imposed on water companies;
- the role of SEPA and the DWQR in monitoring and enforcing these obligations;
- Scottish Water's future requirements under these directives and, in particular, their impact on the investment programme; and
- the indicative solutions that could be employed to ensure compliance.

Scottish Water also set out its broad assessment of the capital investment it considered would be necessary to meet the directives; the key determinants of drinking water quality and environmental performance; and the company's view on the impact on customers if it were to fail to meet the required standards. Finally, the SIRs outlined the measures that the company proposed for meeting the standards.

These SIRs provided helpful background information on Scottish Water's proposals in these areas. The Commission stated that it would set out its views when it received Scottish Water's draft business plan, noting that this was likely to include advice on:

- the overall level of expenditure;
- the use of innovative approaches adopted by Scottish Water (to reduce costs or to improve performance);
- the efficiency of the proposed expenditure; and
- the extent to which this expenditure would impact on customers' bills.

### **Meeting demand from new customers**

In Commission Note 14 the Commission reviewed the main points and proposals in Scottish Water's SIRs on the future capital investment required to meet increased demand arising from new customers connecting to the water and wastewater networks.

In its SIR Scottish Water set out the statutory framework and associated ministerial objectives that underpin investment requirements in this area. It also explained its forecasts in relation to the number of properties served by the water and wastewater networks (forecast to increase by 21% by 2035), and its assessment of how this additional demand would be met.

Scottish Water went on to provide provisional estimates of the investment required to connect new properties to the network, and its proposals as to how this investment would be financed.

Scottish Water proposed to 'ring-fence' investment in this area, as is the case in the current period. This would mean that at the end of the regulatory control period an adjustment would be made to the proposed allowances for investment in future periods in order to reflect actual expenditure in the previous period.

In 2009 the Commission had considered that ring-fencing was the best approach. However, there was greater understanding now about the cost of connecting new properties. Since there was less uncertainty, a ring-fence might not be necessary for 2015-21.

## 5

## The key regulatory inputs: The Commission's response to Scottish Water's draft business plan and the ranges it set for the Customer Forum

### Introduction

Scottish Water published its draft business plan for 2015-21 on 30 October 2013. The Commission welcomed the plan, and in particular the company's focus on customers and the increased emphasis on innovation. We also said that we intended to publish a number of notes which would provide an assessment of the plan and inform further discussions between Scottish Water, the Customer Forum, and other stakeholders.

In effect the Commission's notes have set out the range of answers consistent with the lowest overall cost of delivering ministerial objectives. The Customer Forum's role has been to advise the Commission, from the customer's perspective, what would be the best 'reasonable' answer within these ranges.

The notes covered the following areas, each of which are considered in more detail below:

- financial assumptions;
- financial strength and closing cash;
- base expenditure;
- levels of service;
- additional priorities for customers; and
- enhancement expenditure.

### Scottish Water's draft business plan: Financial assumptions

In Commission Note 16 the Commission presented its view of the financial assumptions Scottish Water had used to underpin its draft business plan for the period 2015-21.

#### Inflation

Scottish Water proposed to use CPI as the measure of inflation when calculating its charges for each financial year, as opposed to RPI, the traditional measure. The Customer Forum was supportive of this change as it believed that customers would recognise CPI as the UK Government's official measure of inflation. The company's draft plan also assumed that CPI would be 2% for each year of the period 2015-21 (consistent with the Bank of England's long-term target for CPI)<sup>12</sup>.

The Commission supported the change, noting also that CPI is the inflation index that is used to adjust many pensions and benefits.

Our analysis indicated that it was reasonable for Scottish Water to base its inflation expectations on expected trends published by the Bank of England. As such, we believed that the forecast CPI of 2% a year was a reasonable assumption.

#### 12

Expectations on CPI later fell to 1.9% a year. Scottish Water and the Customer Forum agreed to use this new figure.



### Outturn expenditure profiles

As at previous price reviews, Scottish Water had applied a forecast of RPI to its base year costs to derive outturn expenditure profiles in the business plan. The company assumed that operating and capital expenditure would inflate by RPI, and that RPI would average 2.9% across the period 2015-21. The company based this forecast on its assessment of the historical differential between CPI and RPI.

Scottish Water's forecast rate for RPI of 2.9% for each year of the review period was based on an estimated 0.9% difference between RPI and CPI. The Commission's analysis suggested that in the past 15 years the difference had generally been smaller than this, in the region of 0.75% per year. We suggested that it would be reasonable to assume a difference of 0.75% per year between RPI and CPI.

### Interest rates on new debt

Although inflation across the economy will affect most of Scottish Water's costs, it does not affect its cash interest payments, which are determined by the rate at which it can borrow from the Scottish Government. Scottish Water's assumed average interest rate on new debt for the period 2015-21 is set out in Table 7 below.

**Table 7: Scottish Water's assumed interest rate on new debt**

2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
3.5%	3.75%	4%	4%	4%	4%	4%	4%

Our analysis indicated that these assumptions were reasonable.

### The presentation of prices

Scottish Water's draft business plan recognised that household budgets remain under pressure, so charges should be set as low as possible. As we explained above, traditional practice has been to link prices to RPI. One advantage of this approach is that it helps private sector companies access index-linked debt, which reduces the current interest charges customers have to finance through their bills.

A problem with RPI, however, is that price reductions relative to RPI inflation can sometimes turn out to be an increase when considered next to the CPI headline that is reported in the media; this may end up disappointing some customers. A link to CPI inflation may be easier for customers to understand.

The Commission proposed an alternative approach, which it felt would be even better from the customer's perspective. This was to set the actual prices (at least for the period 2015-18) that customers will pay. We considered that this would help household customers plan their budgets more easily. It would also be in keeping with the approach used for the current regulatory control period, where we set an overall charge cap for the whole regulatory control period.

We further suggested that Scottish Water could take account of the planned increase (in line with RPI) that was expected in April 2014. This would allow the company to smooth prices over a seven-year period (2014-15 and 2015-21).

### **Scottish Water's draft business plan: Financial strength and closing cash**

Commission Note 17 outlined the Commission's view of the comments on financial strength that Scottish Water had made in its draft business plan. In the plan Scottish Water suggested that it would:

- achieve an average in interest cover of 1.6x and gearing of 54% over the period 2015-21; and
- accumulate £115 million of cash, including £93 million of gilts reserve, by March 2021.

The target level of cash assumed that:

- the Scottish Government would provide £120 million a year of borrowing;
- Scottish Water would enter the new price control with about £248 million of cash that would be used to finance the capital enhancement programme that was started in the current price control period and would be carried over into the next.

The Commission agreed that Scottish Water should maintain strong financial ratios that are broadly consistent with a shadow credit rating of A3/A-.

Our note explained that water and waste water companies that are not financed within a securitised structure would typically seek to satisfy Ofwat's requirement to maintain a strong investment grade rating in their core business by targeting gearing around 60-65% and cash interest cover of 1.6-1.8x. Unlike companies in England and Wales, Scottish Water has no access to index linked borrowing.

As a consequence, in comparison with its peers, Scottish Water's gearing appears strong while its interest cover looks weak. Furthermore, the structure of many of the companies in England and Wales means that direct comparisons with Scottish Water are problematic. Many of the companies in England and Wales have very complex financial structures, which may affect decisions about how the business is managed.

In our view, however, it is important when assessing financial strength to consider financial ratios together, rather than looking at them individually. In light of this it was our belief that Scottish Water was targeting an appropriate level of financial strength.

The Commission's tramlines approach provides assurance to Scottish Water and its customers that the company's financial strength will be maintained in the long term beyond this price review. Our view, therefore, was that the closing cash balance (assuming performance in line with the regulatory contract) should be in the range of £20-£40 million.

## Scottish Water's draft business plan: Base expenditure

Commission Note 18 outlined the Commission's view on Scottish Water's operating and capital maintenance costs (together known as 'base expenditure'). It is appropriate to consider these two areas of cost together because a company has quite significant discretion in how it allocates expenditure between them.

Scottish Water's draft business plan proposals were as shown in Table 8.

**Table 8: Scottish Water's base expenditure proposals**

<b>£m, 2012-13 prices</b>	<b>2015-16</b>	<b>2016-17</b>	<b>2017-18</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>
Capital maintenance expenditure	275	277	279	281	283	285
Total operating expenditure	506	508	506	504	503	503
- PPP charges	152	152	152	152	152	152
- Controllable operating expenditure	237	237	236	234	232	230
- Non-controllable operating expenditure	107	107	107	107	107	107
- Cost of new obligations	10	11	12	12	12	14

### Capital maintenance

In its draft business plan Scottish Water proposed an increase of about 12% on its average annual maintenance expenditure for the current regulatory control period (2010-15).

**Table 9: Annual maintenance expenditure**

Predicted five-year average capital maintenance for 2010-15 (2012-13 prices)	£249m
Proposed average annual investment 2015-21 (2012-13 prices)	£280m
<b>Increase</b>	<b>12%</b>

Our analysis confirmed that the proposal was reasonable, given that Scottish Water intended to provide higher levels of service and, in line with the companies in England and Wales, was making greater use of assets with shorter lives in order to comply with EU public health and environmental standards. At our request, the Independent Assuror also reviewed Scottish Water's capital maintenance proposals in detail. The Independent Assuror concluded that the increases were reasonable.

### Scottish Water's relative service and base expenditure performance

During the regulatory control period 2010-15, Scottish Water was required to improve services and meet the costs of operating new assets from its existing budget for operating expenditure. This was a demanding challenge. It also required Scottish Water to save money from other budget areas when it needed to spend more on maintaining its assets. It appears that it was able to do so.

The Commission believes that a similar challenge is appropriate for this price review. We have conducted substantial analysis of Scottish Water's relative unit costs and the scope for this to improve, as we wanted to understand the cost implications of improving levels of service.

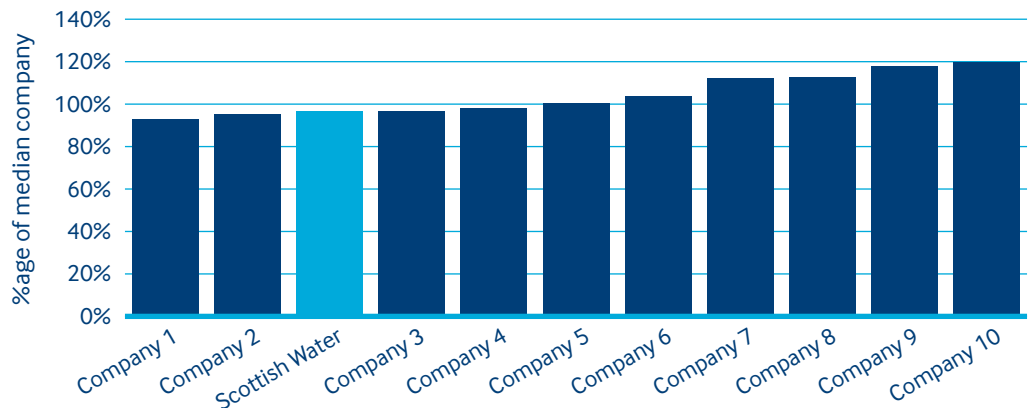
Given that the information to use the Ofwat models is no longer available, we compared adjusted unit costs (reflecting the principal drivers of costs).

Scottish Water inherited nine public private partnership (PPP) wastewater treatment contracts from the three former water authorities. The charges associated with these PPP contracts currently constitute around 30% of Scottish Water’s total operating expenditure. There is little that Scottish Water can do to mitigate the cost of these contracts. Hence, they were removed from our comparisons.

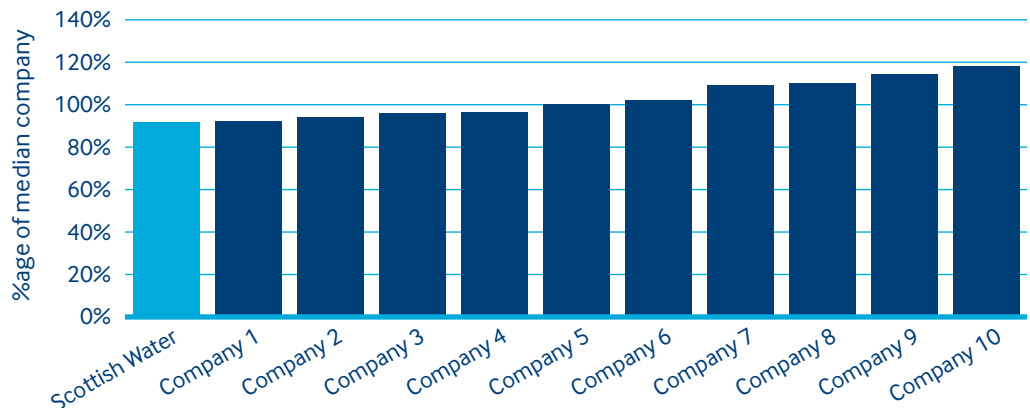
The ‘raw’ results of assessments of efficiency are adjusted to take account of ‘special factors’. We scrutinised any claim for ‘special factors’ very carefully. This analysis does not take account of differences in the levels of service provided to customers or of operational performance. Our results are shown in graphical form below. Two measures of unit costs are examined:

1. Combined operating and capital maintenance expenditures without PPP activities and without special factors.
2. Combined operating and capital maintenance expenditures without PPP activities but with special factors.

**Figure 2: Controllable operating expenditure and capital maintenance unit cost efficiency (excluding PPP activities)**



**Figure 3: Controllable operating expenditure and capital maintenance unit cost efficiency (excluding PPP activities and including special factors)**

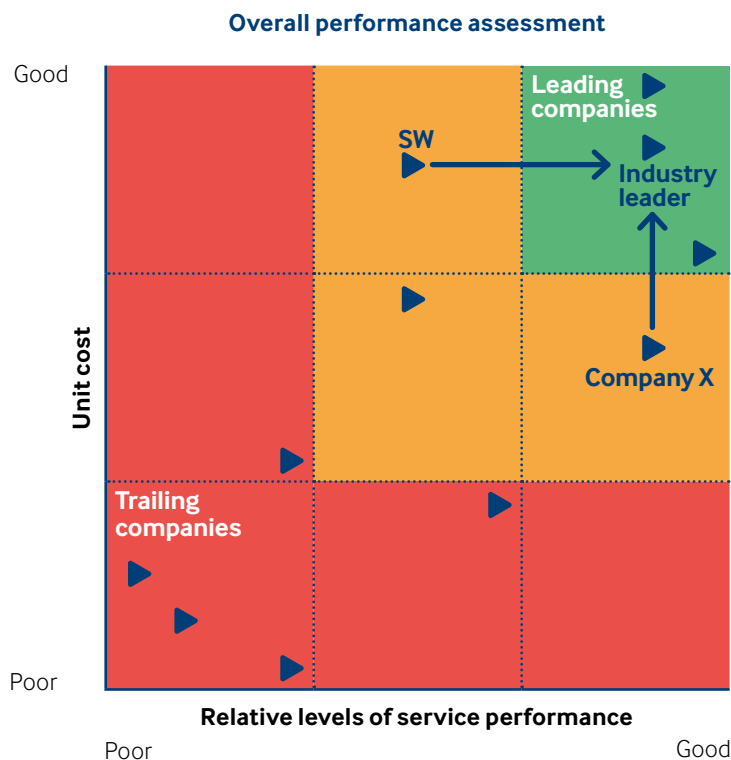


Costs are only one part of an assessment of overall efficiency. Ofwat’s econometric models did not attempt to value improvements in levels of service in financial terms. We adopted an approach that attempts to identify companies which had higher unit costs than Scottish Water but which delivered broadly the same level of service as the industry leaders.

The figure below shows Scottish Water’s performance relative to that of the water and sewerage companies in England and Wales, with operating and capital maintenance expenditure unit cost<sup>13</sup> performance on the y-axis and relative level of service performance<sup>14</sup> on the x-axis.

**Figure 4: Efficiency assessment<sup>15</sup>**

**Unit cost = operating expenditure and capital maintenance**



**13**  
Average of the years 2011-12 and 2012-13, excluding PPP charges.

**14**  
As measured by Ofwat’s 2012-13 key performance indicators.

**15**  
Company X is performing better than Scottish Water on levels of service but worse on its overall level of costs. This explains its position to the right of and below Scottish Water. The comparison suggests that Scottish Water could reduce its costs by around 11% if it only had to deliver its current level of service and operational performance. We estimate therefore that for Scottish Water to match the leaders in customer service (while maintaining its position on costs) would broadly represent an efficiency challenge of 11% over the regulatory control period.

We estimate that at its current level of efficiency, Scottish Water’s level of controllable operating costs would have to be £28 million higher (£255 million against the base year £227 million) if its levels of service were to match the overall best performing company.

Our target for Scottish Water is that by the end of the regulatory control period its relative service performance should be equivalent to that of the best companies today but without any increase in its controllable operating costs. This will require the company to improve its efficiency by 11% on top of the reduction in unit costs at 0.6% per year set out in its draft business plan.

## Scottish Water's draft business plan: Levels of service

The resources made available by improvements in operating efficiency can partly be used to ensure that prices increase at a rate below the general level of inflation and partly to achieve a significant improvement in levels of service. Our views on the scope of service improvements for discussion by the Customer Forum and Scottish Water were set out in Commission Note 19.

In its draft business plan Scottish Water proposed that its levels of service should be measured through the following four indicators:

### 1. The OPA

Scottish Water proposed that the OPA with 17 measures should be retained with only some minor adjustments to reflect agreements made with SEPA and the DWQR. The company expected to achieve a performance of 380-400 points by 2015 and to maintain this over the 2015-21 period.

### 2. The Customer Experience Measure (CEM)

Scottish Water proposed to introduce this new measure of customer satisfaction from 2015, when it would replace the current customer satisfaction measure. The CEM is broadly similar, but not identical, to the SIM that is used in England and Wales.

The overall CEM score would be calculated from the sum of a quantitative measure and a qualitative measure, each evenly weighted at 50%.

### 3. Wholesale key performance indicators (KPIs)

Scottish Water proposed to continue to monitor the overall performance of its wholesale service to the licensed providers. The measure it uses takes account of wholesale services and responses to requests that relate to trade effluent, connections, disconnections, bye-laws, metering and billing.

### 4. Additional measures

Scottish Water suggested that it would produce additional measures for areas of service that have been highlighted by the Customer Forum as being priorities for customers that are not already being measured.

The Commission indicated its support for the introduction of new measures to monitor and reward improvements in service. At the same time, it emphasised the importance of demonstrating that levels of service measured by the principal indicators used in previous regulatory periods are, at the very least, maintained. The specification of, and targets for, the additional service indicators were a matter for discussion and would be developed through consultation between Scottish Water and the Customer Forum.

## Scottish Water's draft business plan: Additional customer priorities

The Customer Forum and other stakeholders had identified potential scope for additional priorities to be included within the investment objectives. These additional priorities would have to be included in the Scottish Ministers' final investment objectives.

In Commission Note 20 we commented that Scottish Water's draft business plan could have gone further in this area. We suggested that investment and operating expenditures allocated to meeting the additional priorities should be judged on how far they would contribute to developing a more resilient, innovative and sustainable water industry in Scotland. It is particularly important to consider how to develop innovative and cost-effective approaches to improving water supplies and wastewater collection in rural communities.

### Scottish Water's draft business plan: Enhancement expenditure

The water and sewerage industry in Scotland is governed by a clear regulatory framework. Scottish Water's draft business plan set out its proposed investment to meet the Scottish Government's objectives for 2015-21. This included investment to deliver two categories of improvements:

- The statutory requirements that are specified in the objectives and are overseen by SEPA, the DWQR or the Scottish Government.
- Other improvements which are included within the ministerial objectives, such as improvements in resilience of supply, levels of service and actions to reduce sewer flooding.

In Commission Note 21 we outlined our views on the timing and pace of the investment programme, the level of innovation, the use of revenue solutions (as opposed to capital expenditure) and Scottish Water's capital efficiency, taking account of the need to meet statutory outcomes and deadlines specified by the Government.

The proposals for enhancement investment in the draft business plan are summarised in table 10 below.

**Table 10: Scottish Water's proposed enhancement investment (£m) (2012-13 prices)**

Category	Statutory	Scope for discussion	Scottish Water's proposed investment (£m) (2012-13 prices)
Improve water service	340.5	130.0	470.5
Improve the environment	196.4	166.2	362.6
Support communities	0.0	73.1	73.1
<b>Total enhancement (exc. completion)</b>	<b>536.9</b>	<b>369.3</b>	<b>906.2</b>
Completion of 2010-15 capital programme	179.8	3.0	182.8
<b>Total enhancement (incl. completion)</b>	<b>716.7</b>	<b>372.3</b>	<b>1,089</b>

The Commission broadly welcomed the proposed investment in capital enhancement, stating that it considered the proposed expenditure in these areas to be reasonable. However, it is critical that Scottish Water should be clear about how and when customers and other stakeholders will benefit from the proposed non-statutory investment.

The Commission noted that there is scope for the Customer Forum to discuss with Scottish Water and other stakeholders how indicators of progress with respect to the non-statutory investments might be defined. Such indicators could be incorporated into the ministerial objectives.

### **Scottish Water's draft business plan: Growth**

In Commission Note 22 we set out our views on the levels of growth and associated costs included in Scottish Water's draft business plan. This was an area where we considered Scottish Water had taken quite a cautious approach. There appeared to be scope to increase the estimate of the level of growth in new household connections. At the same time, the proposed revenue profile expected from the non-household sector appeared to be optimistic.

In the note we set out our view of likely growth and suggested an approach to mitigate the risk of opting for higher growth rates. Since the note was written it has become clear that investments to meet the growth in the number of customers do not achieve payback within the regulatory control period. This limits the amount of investment in growth that can be afforded within the cash resources available to Scottish Water.

We also noted that the Customer Forum might wish to discuss with Scottish Water whether or not it is necessary to ring-fence growth investment and expenditure (as Scottish Water had proposed), given that a review of the investment required was planned for 2018. This would provide an opportunity to adjust levels of allowed for expenditure.



## 6

## The key regulatory inputs: Comparison of the Commission's expectations and the Minute of Agreement

### Introduction

Chapters 3 and 4 outlined the process whereby the Commission set out its expectations of what would constitute the range of regulatory inputs consistent with Scottish Water delivering the ministerial objectives at the lowest overall cost. Chapter 5 summarised the Commission's response to the draft business plan and the guidance it issued to inform discussion between Scottish Water, the Customer Forum and other stakeholders.

In the draft business plan Scottish Water set out its proposed levels of service and environmental performance for the 2015-21 regulatory control period. It also set out Scottish Water's financial projections and associated profile of prices for household and wholesale customers.

Following publication of the draft plan there was a period of engagement between Scottish Water and the Customer Forum. This process led, ultimately, to the 'Minute of Agreement' between the two parties, which is reproduced as Appendix 4.

Scottish Water will shortly publish an updated business plan which reflects the Commission's decisions in this draft determination and the changes the company agreed with the Customer Forum. The updated business plan will include some minor changes to the drinking water quality and environmental programmes to reflect the latest priorities that have been agreed with the DWQR and SEPA.

This chapter reviews the consistency between the Commission's decisions on the appropriate ranges and the Agreement.

### Financial assumptions

#### The Commission's decision on the appropriate range

The Commission decided that an estimate of the increase in CPI over the regulatory period of around 2% a year was reasonable. However, it decided that the 0.9% a year difference between projected increases in the RPI and the CPI was not supported by the available evidence. It recommended that the difference should be 0.75% a year.

The Commission considered that a forecast interest rate of 4.0% was reasonable. It noted that this was slightly higher than the rate currently available to Scottish Water, but that interest rates were likely to increase to more normal levels during this regulatory control period.

The assumed level of borrowing should be £120 million each year.

The Commission set out its view that the level of Scottish Water's cash balance at the end of the regulatory control period should be in the range £20-£40 million.

**The Agreement between the Customer Forum and Scottish Water**

The Agreement assumes expected increases over the regulatory period of 1.9% per year in the CPI and 2.65% per year in the RPI. Further, it assumes an interest rate of 4.0%, a level of borrowing of £120 million per year and an ending cash balance of £20 million.

**Base expenditure and efficiency****The Commission's decision on the appropriate range**

The Commission considered that Scottish Water's proposals for base expenditure and cost reduction were broadly reasonable. However, it considered that Scottish Water should improve its efficiency by improving the levels of service it provides to customers and its overall operating performance within the proposed budget.

The Commission considered that the proposed reduction in expenditure should ensure that Scottish Water maintains its position of having among the lowest controllable unit costs in the British industry.

The Commission was keen that levels of service should be improved such that Scottish Water achieves in its levels of service and operational performance what it has already achieved in unit costs.

**The Agreement between the Customer Forum and Scottish Water**

The Agreement includes substantial measures to improve customer service and revised targets that are consistent with overall industry leadership.

**Enhancement investment****The Commission's decision on the appropriate range**

The Commission considered that the proposed level of capital expenditure was broadly reasonable.

It was noted that further work was being carried out to ensure that there is full and proper definition in the capital expenditure proposals. This has been completed. In particular, there have been some amendments to the draft business plan to reflect about £12 million of investment to meet outcomes required under the Water Framework Directive (which was transposed into Scottish law in 2003 by the Water Environment and Water Services (Scotland) Act (WEWS) 2003).

There was also an inconsistency in Scottish Water's draft business plan concerning the calculation of growth expenditure.

**The Agreement between the Customer Forum and Scottish Water**

The Agreement is consistent with the Commission's views. The inconsistency in the calculation of growth expenditure has been rectified. There has been a re-phasing of investment in the second half of the period (termed 'IR18'), some of which will be delayed until after March 2021 (this will not impact on statutory requirements).

## Levels of service to customers

### The Commission's decision on the appropriate range

The Commission wanted to see further improvements in levels of service to customers and in the operational performance of Scottish Water. It advised that:

- the target range for the OPA could be increased;
- there should be more transparent measures for the wholesale service provided to the retail licensed providers;
- it may be worth reviewing the weightings in the proposed customer satisfaction index;
- there may be new areas of importance to customers that the Customer Forum may wish to request from Scottish Water; and
- there may be a place for a more aspirational comparison of Scottish Water's performance.

### The Agreement between the Customer Forum and Scottish Water

The Agreement confirms the aspiration that Scottish Water's customer service performance should be 'best in class'. The Customer Forum and Scottish Water have agreed a three-tier approach:

- Scottish Water will plan to achieve an equivalent<sup>16</sup> OPA score at or above 400 points, although it is recognised that this is unlikely to happen consistently based on experience in England and Wales and the inevitability of 'one off' impacts.
- Scottish Water plans to achieve an OPA score at, or above, the leading England and Wales companies' threshold in every year. Again, it is accepted that this may not be achieved in every year due to one-off significant events.
- Scottish Water commits to achieving an average OPA score across 2015-21 that exceeds the leading companies' performance threshold. This translates to an average score across 2015-21 that exceeds 382.5 points.

The Agreement also allows for independent verification of the OPA scores, a reduction in the response time for formal complaints from 10 days to 5 days and the formal reporting of any exclusions to the Customer Forum (or its successor body).

The Customer Forum has also agreed with Scottish Water that a new Customer Experience Measure should be developed by March 2015 for both household and business customers. In addition it was agreed that further work is required to understand business customers' perceptions of service and to develop improved working relations between business customers and Scottish Water.

Further work on benchmarking Scottish Water's customer satisfaction against other utilities and companies in other sectors has been agreed, as has a range of enhanced service activity measures in the following areas:

- external flooding,
- visible leakage,
- carbon footprint reductions,
- extreme weather events, and
- complaints to the Scottish Public Services Ombudsman (SPSO)<sup>17</sup>.

Scottish Water has committed to deepening customer engagement on issues such as protecting vulnerable customers and establishing customer driven priorities. It has also agreed the importance of improved customer education, care and support programmes in delivering cost-effective improvements in water and wastewater services.

#### 16

The equivalent score reflects that the impact of agreed changes to the measurement system in Scotland mean that Scottish Water's equivalent score will be between 3 and 4 points lower than the recorded figure in England and Wales. Only one company in England and Wales has previously achieved an equivalent score above 400 points.

#### 17

The SPSO has a statutory role to review second tier (initially unresolved) complaints from Scottish public bodies and others providing public services. It acts in this role for some, but not all, of the licensed retail providers.

## Growth in the customer base

### The Commission's decision on the appropriate range

The Commission considered that the level of household growth included in Scottish Water's draft business plan appeared low. Conversely, the Commission noted that the growth in the non-household customer base was potentially optimistic.

Further analysis has shown that increasing the growth rate uses more cash than it generates during the regulatory control period. Hence, there is a limit to the growth in the household customer base that is consistent with the financial assumptions underpinning the Strategic Review.

### The Agreement between the Customer Forum and Scottish Water

The assumption on household growth has been increased from an average of 0.67% a year in the draft business plan to an average of 0.74% a year, consistent with the Commission's views. This has led to increased costs over the 2015-21 period of some £10 million. The actual outturn costs in the first three years of the period will be taken into account as part of the IR18 process.

The draft business plan incorporated two broadly offsetting errors that have now been corrected. They relate to a £21 million understatement of the requirement for 'reasonable cost contributions' from Scottish Water and an understatement of £3-4 million a year in the revenue received by Scottish Water from the 'infrastructure charge' paid for new connections.

## Prospects for prices

### The Commission's decision on the appropriate range

The Commission expressed a view that household bills were likely to have to increase by between CPI-0.2% and CPI-0.4%. Wholesale charges should increase in line with household charges.

### The Agreement between the Customer Forum and Scottish Water

Taking into account Scottish Water's decision to limit the increase in household prices in 2014-15 to 1.6%, the Customer Forum and Scottish Water agreed that Scottish Water's revised business plan would assume

- nominal price increases for household customers of 1.6% per year for 2015-18;
- an overall cap on household charges of CPI-1.75% for the regulatory period 2015-21; and
- increases in wholesale charges of CPI-0.3% per year for 2015-21.

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## The Commission's conclusions

The Commission welcomes the efforts that Scottish Water and the Customer Forum have made to identify customer priorities and to reach agreement on levels of service that will be included in Scottish Water's revised business plan for 2015-21.

### Operating and investment expenditures

Taking account of the agreement on these matters and the ranges for key regulatory parameters detailed in the previous chapters of this draft determination, the Commission has decided that the charge cap for the period 2015-21 should be based on the following assumptions (with all values at 2012-13 prices):

- operating expenditure – £505 million per year;
- capital maintenance expenditure – £280 million per year;
- total enhancement investment (including completions) – £1,356 million<sup>18</sup> for 2015-21;
- end of period cash balance – £20 million.

### Service improvements

Within these resources Scottish Water is expected to improve its service performance over the regulatory period so that:

- it maintains its OPA score within a range of 380 to 400 points throughout the period;
- it ranks among the leading UK water companies on the CEM to be introduced by March 2015; and
- it ranks among the leading UK utilities for customer satisfaction.

In addition, Scottish Water will implement service improvement measures to address: external sewer flooding, visible leakage, reduction in carbon emissions, managing responses to extreme weather events, and minimising escalated or upheld complaints to the SPSO.

Scottish Water will also set aside at least £40 million for investment to meet quality, environmental and service improvement objectives to be identified at the 2018 Interim Review. Finally, the company will increase the financial payments made to customers who suffer unplanned interruptions to their water supply or internal sewer flooding.

### Charge caps

The Commission's mandate is to set charges at a level that will permit Scottish Water to meet the Scottish Government's objectives at the lowest reasonable overall cost. We have challenged Scottish Water to build on the successes of the last two regulatory periods by improving its operational efficiency and the delivery of its investment programme. Our charge caps require that the company should continue to outstrip its comparators while also improving its level of service performance.

For household customers, Scottish Water will be permitted to increase its charges over the full period 2015-21 by no more than CPI minus 1.8%. For the three year period from 2015-16 to 2017-18 its charges will increase by 1.6% per year in nominal terms.

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This figure reflects Scottish Water's latest estimate of enhancement expenditure of £1,109 million, including completion costs, and gross growth expenditure of £247 million.

For business customers, Scottish Water will be permitted to increase its wholesale charges at no more than CPI – 0.3% per year over the period 2015-21.

#### **Benefits for Scottish households**

Our draft determination offers the prospect of charges rising by less than inflation for all household customers. In proposing these charges we have not compromised the prospects for future charges, nor have we cut any corners with the delivery of all of the Scottish Government's objectives for the industry.

In this time of economic uncertainty, it is important that customers can look forward to water and sewerage charges that will not increase by more than the rate of consumer price inflation for up to the next six years and which offer certainty about nominal increases for the next three years. At the same time our targets for levels of service performance mean that Scottish Water should continue to improve all aspects of its customer service in order to meet the goal of being the leading water company among its comparators in the rest of the UK.

#### **Benefits for businesses and the public sector in Scotland**

Retail competition for the non-residential sector in Scotland has permitted an increasing number of non-residential customers to negotiate better deals with their retail supplier. Our cap on wholesale charges and our approach to 'default' tariffs should encourage retailers to offer improved and more tailored levels of service to all of their customers. Almost all non-residential customers should see their bills fall in real terms and the level of service should improve substantially.

#### **Benefits for the environment in Scotland**

Our draft determination provides the resources that will enable Scottish Water to improve the quality of its water supply and to reduce its impact on the environment. The company has made substantial progress in both respects over the period 2010-15 and the funds provided for enhancement investments will enable it to meet the objectives of the Scottish Government. At the same time, we have encouraged Scottish Water to experiment with small scale and innovative approaches to address environmental and other issues rather than relying exclusively upon capital-intensive technologies.



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## Next steps

**We welcome comments on our draft determination.**

**Please send your views to:**

Judy Tait  
Water Industry Commission for Scotland  
First Floor  
Moray House  
Forthside Way  
Stirling  
FK8 1QZ

Email: [draftrepresentation@watercommission.co.uk](mailto:draftrepresentation@watercommission.co.uk)

We should receive representations on or before 12 June 2014. We will publish all responses to this consultation unless respondents request otherwise.

## Ministerial SRC commissioning letter

**Energy and Climate Change Directorate**  
Climate Change and Water Industry Division

T: 0131-244 0246 F: 0131-244 0211  
E: Bob.Irvine@scotland.gsi.gov.uk



Professor Gordon Hughes  
Water Industry Commission for Scotland  
First Floor  
Moray House  
Forthside Way  
Stirling  
FK8 1QZ

13 June 2012

Dear Gordon

### **STRATEGIC REVIEW OF WATER CHARGES: 2015-20**

I am writing to inform you of the broad arrangements that the Government wishes to be followed in the next Strategic Review of Water Charges (SRC). The Water Industry (Scotland) Act 2002, as amended by the Water Services etc. (Scotland) Act 2005, places duties on both the Scottish Ministers (Ministers) and the Water Industry Commission (the Commission). In particular it requires Ministers to specify the time period for the SRC and the date by which a Determination must be made.

In agreeing these arrangements Ministers wish to build on those put in place successfully for previous regulatory periods. In particular, they note the importance of a defined investment programme ahead of the start of any regulatory period which is essential to maximise efficient delivery and that sufficient time is required for the planning of such a programme.

Ministers acknowledge the benefits of planning over a longer timeframe than a single regulatory period as this provides certainty for the industry and customers as well as the supply chain. They fully endorse the Commission's intention to require Scottish Water to prepare a 25 year strategic vision and request each five year investment plan is developed in a manner so as to support that vision.

Ministers commend the substantial improvements in efficiency made by Scottish Water over recent years and acknowledge that these have been made possible by robust comparison with the performance already achieved by water companies south of the border. Ministers accept that the Commission can no longer rely entirely on these comparisons and that the economic regulatory regime in Scotland must continue to evolve.

In evolving the regulatory mechanisms to keep Scottish Water at the forefront of efficiency levels and enable it to meet the challenges of the future, Ministers request that there is greater engagement with customers on the choices on levels of service improvement. They also request that the Commission specifically consider ways in which to facilitate much

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[www.scotland.gov.uk](http://www.scotland.gov.uk)





greater innovation within the industry to meet, for example, future challenges on sustainability and climate change.

### **SRC 2015-20: Ministerial Specifications**

The following sets out the specific requirements Ministers wish to be met in the next Strategic Review of Charges (SRC).

#### Time period and date of publication for the Determination:

The Commission is to undertake a Strategic Review of Charges for the five-year period 2015 to 2020, consistent with the planning horizon used in the Quality and Standards 4 process. It shall also consider the implications and advantages of moving to a six-year period as recently proposed by the Commission and Scottish Water. The Final Determination of Charges should be published by the end of November 2014. All future references to the five regulatory period in this letter should also reflect the possibility of moving to a six year period.

#### Principles of Charging:

Ministers' policy is for charge caps that are affordable and broadly stable. This policy will underpin their Principles of Charging for the next regulatory period. Ministers will confirm the principles of charges to be applied by way of a public statement in 2014 following appropriate engagement.

#### Statement of Objectives:

Ministers will finalise their objectives in September 2014.

Ministers agree in principle with the draft Objectives attached at Annex B. They expect the Q&S4 Project Management Team and with advice from the Output Monitoring Group to engage on the draft investment objectives for 2015-20 and outline objectives for 2020-25 in summer 2012. Thereafter they expect Scottish Water and regulators to develop detailed investment plans. The details of a planning framework within which Ministers expect this to be undertaken are set out at Annex A.

Ministers recognise that the majority of the investment programme, and therefore their objectives, will be driven by statutory obligations in relation to drinking water quality and the environment. However, in calculating the funding necessary to deliver the draft objectives, it is important that full account is taken of both customers' and Government's priorities. It will be necessary to demonstrate how these objectives will contribute to the Government's purpose of increasing sustainable economic growth and, in particular, to Scotland's climate change targets.

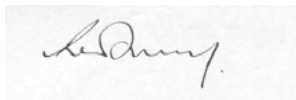
Ministers note that in the 2010-15 regulatory period, the Final Determination provided for £180m to be allocated during the period to finance outputs that would be defined as a consequence of studies. In principle, Ministers are supportive of such a mechanism. However, they request that an analysis is undertaken of the effectiveness of this approach in the 2010-15 period.

### Timetable

In agreeing the timetable for the SRC, Ministers ask that all parties ensure that, in keeping with good practice, sufficient time is made available to ensure appropriate consultation with the wider stakeholder group and for the Government's own public engagement.

I look forward to receiving regular reports on the progress of the strategic review.

I am copying this letter to the Chair of Scottish Water, the Chair of Scottish Environment Protection Agency, the Drinking Water Quality Regulator for Scotland, the Chair of Consumer Focus Scotland and the Chair of the Competition Commission.



BOB IRVINE

Annex A

### **Framework for Developing Investment Plans for Q&S4**

**Ministers need to be advised by the Q&S4 Project Management Team on their options and risks on investment needs going forward. The following framework is intended to help guide the work of all groups contributing to that process. Ministers will also look to the outcomes of the Scottish Water customer research and willingness to pay surveys, the evidence from the wider Scottish Water Customer Engagement and the Customer Forum's considerations of the evidence to identify customer's priorities for investment and to understand the standards of service expected.**

#### **Context and Process for Confirming Ministerial Objectives for Q&S4**

The [National Performance Framework](#) underpins delivery of the Scottish Government's agenda which supports the outcomes-based approach to performance. At the heart of this framework is the Government's Purpose:

*To focus government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth.*

In setting their priorities for investment, Ministers will wish to ensure that these are aligned with the Government's Purpose and five underpinning Strategic Objectives. In particular::

- **Size of Investment Programme** – should be planned to be between £450m and £500m per annum.
- **Planning Period** - should be planned for ten years to be delivered over two five year regulatory periods (2015-2020 and 2020-2025). Plans should also reflect the possibility of moving to a six-year period. The length of the regulatory period will be confirmed in the light of comments received from the engagement on the plans for the next regulatory period.
- **Government lending** – in the light of the consultation on the Principles of Charging for 2015-2020, Ministers will confirm the amount that government is able to lend over that 5 year period. It should be assumed that less Government lending will be available than for the period 2010-15.
- **Promoting more sustainable outcomes** - Scottish Water is vital to a sustainable Scotland. Scottish Water will continue to act in accordance with the principles of sustainable development and to work to maximise the benefit to the environment, economy & society in the delivery of its services. Scottish Water will take appropriate and cost effective steps to reduce the overall energy demands of its services, to become more energy efficient and to deliver more renewable power for the benefit of Scotland. Where possible, operational approaches should be sought and implemented wherever it is more economic to do so.
- **Delivering more efficient and effective outcomes** – the industry is reaping the rewards of allowing time for comprehensive studies of investment needs to be done ahead of decisions being taken. Ministers endorse this approach.

- **Customer involvement** - Ministers support the aspiration to increase and improve customer involvement in the setting of investment priorities to deliver the levels and quality of service they deserve for the charges they pay. They expect Scottish Water and its regulators to assist fully in the work of the Customer Forum.
- **Setting the Outputs of the Investment Programme** - Ministers Objectives will specify the outcomes they expect SW to achieve. It is for the quality regulators and customer representatives, in consultation with SW, to define the outputs required to deliver these outcomes and to do so in the timeframes set out by the Water Industry Commission for Scotland.

## ANNEX B

## WATER INDUSTRY

## OBJECTIVES FOR THE PERIOD 1 APRIL 2015-31 MARCH 2025

The overall purpose of these Objectives is to ensure that the focus of water and sewerage services is on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth.

### 1. A Wealthier and Fairer Scotland

To deliver better and more efficient public services that enhance our quality of life, support sustainable economic growth and assure those that fund and rely on them that their public services are responsive, provide value for money and are continually improving, Scottish Water shall in respect of:

#### 1.1 ASSET MAINTENANCE

Ensure that assets are maintained so that there is no overall deterioration in performance from that required to be achieved by 31 March 2015.<sup>1</sup>

#### 1.2 SERVICE STANDARDS OBJECTIVES

Build on the improvements made to date and continue to improve services to customers including those measures<sup>2</sup> agreed with the Customer Forum.

<sup>1</sup> <http://www.scotland.gov.uk/Resource/Doc/917/0088613.pdf>

<sup>2</sup> Measures include internal sewer flooding, interruptions to supply, malodour, external sewer flooding, drinking water discolouration, taste and odour of drinking water supplies, customer satisfaction etc

### 1.3 STRATEGIC CAPACITY FOR NEW DEVELOPMENT OBJECTIVES-

(a) Identify and make provision to service demand for new 'strategic' capacity to meet all new housing development and the domestic requirements of commercial and industrial customers for the period 1 April 2015 to 31 March 2025. In doing so, Scottish Water shall take account of extant development plans and their associated action programmes, the General Register Office for Scotland's population projections<sup>3</sup> and the SEPA/Scottish Water *Memorandum of Understanding on the Impact of Proposed Development on the Public System*.<sup>4</sup>

(b) Prioritise the delivery of that part of the investment specified under 1.3(a) in accordance with:

- the spatial priorities identified in the National Planning Framework,
- development priorities identified by local authorities in their Structure Plans/Strategic Development Plans; and
- associated action programmes and Local Plans/ Local Development Plans and Local Housing Strategies.

In addition, so as to minimise the likelihood of redundant assets, Scottish Water shall act in a manner so as to ensure that such 'strategic assets' are delivered in support of committed development. This shall be ascertained in accordance with the developer confirming, as a minimum, the following:

- (i) Land ownership or control;
- (ii) The development is supported by the local plan and/or has full planning permission;
- (iii) The time remaining on the current planning permission;
- (iv) That plans are in place to mitigate any network constraints that will be created by the development through a minute of agreement with Scottish Water; and
- (v) Reasonable proposals in terms of annual build rate within the approved development.

<sup>3</sup> Projected Population of Scotland (2008-based), published by GROS 21<sup>st</sup> October 2009

<sup>4</sup> [http://www.sepa.org.uk/pdf/policies/mou\\_sepa\\_scottishwater.pdf](http://www.sepa.org.uk/pdf/policies/mou_sepa_scottishwater.pdf)

#### 1.4 EFFICIENT PUBLIC SERVICES

To support a Wealthier and Fairer Scotland, Scottish Water is required to identify and deliver longer term investments which will reduce the future costs of service delivery. In particular, Scottish Water shall work with other stakeholders to identify and pursue opportunities available to achieve more innovative and sustainable means of delivering services.

## 2. A Healthier Scotland

To support the delivery of the Scottish Government's Healthier strategic objective, Scottish Water shall contribute to improvements that help people to sustain and improve their health. In particular, it shall in respect of:

### 2.1 DRINKING WATER QUALITY

Reduce the risk of non compliance with the Drinking Water Directive 98/83/EC, the Water Supply (Water Quality)(Scotland) Regulations 2001 and the Cryptosporidium (Scottish Water) Directions 2003<sup>5</sup>, by improving the resilience to risks as identified in its Drinking Water Safety Plans;

### 2.2 SECURITY OF SUPPLY

- (a) Provide an appropriate level of physical security to Security Service standards agreed with the Scottish Government and the Drinking Water Quality Regulator;
- (b) Provide the necessary improvements to provide a level of service in water supply zones, to be agreed with the Drinking Water Quality Regulator, such that these zones are adequately protected against the risk of water shortages; and
- (c) Maintain a sufficient supply of water in all water supply zones that reflects the most cost effective operating regime, and takes account of the opportunities for demand management including leakage control and water efficiency measures.

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<sup>5</sup> These Directions are currently under review.



### 3. A Greener Scotland

To support the delivery of the Scottish Government's Greener strategic objective, Scottish Water shall contribute to improvements to Scotland's natural and built environment and the sustainable use and enjoyment of it. In particular it shall as regards:

#### 3.1 ENVIRONMENTAL WATER QUALITY

(a) Support compliance with the Water Framework, Marine Strategy Framework and Urban Wastewater Treatment Directives:

- (i) reduce the impact of its discharges, abstractions and impoundments so as to contribute to the achievement of the environmental objectives for water bodies and protected areas in line with the measures identified in the River Basin Management Plans.
- (ii) undertake strategic studies to understand future investment requirements for discharges and abstractions identified as potentially contributing to the failure of environmental water quality objectives in line with the requirements of the River Basin Management Plans.
- (iii) work with SEPA and licensed providers to undertake catchment management and customer education to reduce the impact of Priority Substances being disposed of via the sewer and drainage system. In addition it shall undertake research which may assist in identifying the effective treatment of substances that catchment management may not be successful in reducing to acceptable levels.
- (iv) improve intermittent discharges identified through modelling and agreed with SEPA as downgrading the aesthetic or environmental condition of water bodies to support compliance with the Urban Wastewater Treatment Directive.
- (v) in partnership with other stakeholders, SW shall take steps to reduce the impact of its discharges on sewage-related litter in the marine environment.

(b) Support the improvement of the water environment by providing first time provision of sewerage where there is a net environmental or public health benefit, and there is community willingness to connect and the scheme is cost effective, as agreed with SEPA.

#### 3.2 NATURE

Support the achievement of the Scottish Government targets for the proportion of natural features in favourable condition, work with Scottish Natural Heritage to identify and undertake management activities at identified sites that will contribute to achievement of the National Indicator '*Increase to 95% the proportion of protected nature sites in favourable condition*'.

#### 3.3 WASTE

Manage the environmental risk associated with sludge historically stored at wastewater and water treatment sites as agreed with SEPA.

### 3.4 CLIMATE CHANGE ADAPTATION

Improve Scotland's resilience to climate change by continuing to invest in modelling the likely impact of climate change on its assets, and where appropriate, investing to manage risks arising from climate change impacts.

### 3.5 CLIMATE CHANGE MITIGATION

Contribute towards Scotland meeting its climate change obligations of achieving greenhouse gas emissions reductions in Scotland of 42 per cent by 2020 and by 80 per cent by 2050, by taking all necessary steps to fulfil its duties and obligations required of it as set out in the Climate Change (Scotland) Act 2009. In particular Scottish Water shall:

- (a) work with relevant stakeholders to assess, pilot, and where appropriate, implement measures needed over the 2015-2025 period to reduce its direct greenhouse gas emissions and energy usage;
- (b) ensure that all investments made as a consequence of these Directions take into account the associated carbon impact; and
- (c) invest to reduce its demand for Scotland's resources (water and electricity from the national grid) where it is cost effective to do so.

## 4. A Safer and Stronger Scotland

To support the Scottish Government's Safer and Stronger strategic objective, Scottish Water will assist local communities to flourish, becoming stronger, safer places to live, offering improved opportunities and a better quality of life. In particular it shall as regards:

### 4.1 FLOOD MANAGEMENT

Take all necessary steps to fulfil its duties and obligations required for the period 2015-2025 as set out in the Flood Risk Management Act. In particular, Scottish Water shall:

- (a) Assess flood risk from sewerage systems and update the latest assessment as required.
- (b) Through its participation in the Metropolitan Glasgow Strategic Drainage Partnership and working collaboratively with their partners continue to deliver its agreed share of the improvements that will reduce the risk of flooding in Greater Glasgow;
- (c) In partnership with responsible authorities, undertake studies to inform investment requirements in future regulatory periods as agreed with the Scottish Advisory and Implementation Forum for Flooding (SAIFF); and
- (d) In partnership with responsible Authorities, commence its agreed share of the investment requirements arising from the flood studies as agreed with the Scottish Advisory and Implementation Forum for Flooding (SAIFF);
- (e) Take action to protect its own assets where they lie within an area vulnerable to flooding.

## Cooperation agreement

1

### CO-OPERATION AGREEMENT

among

**THE WATER INDUSTRY COMMISSION FOR SCOTLAND**, a body corporate established under section 1 of the Water Industry (Scotland) Act 2002 (the "2002 Act") and having its principal office at First Floor, Moray House, Forthside Way, Stirling FK8 1QZ (the "Commission")

**SCOTTISH WATER**, a body corporate established under section 20 of the 2002 Act and having its head office at 6 Castle Drive, Dunfermline, Fife KY11 8GG ("Scottish Water"); and

**THE NATIONAL CONSUMER COUNCIL**, a body corporate established under section 1 of the Consumers, Estate Agents and Redress Act 2007 operating as Consumer Focus (the "Council"), acting through its committee for Scotland ("CFS") having its principal office at Royal Exchange House, 100 Queen Street, Glasgow G1 3DN

#### Whereas

- (1) The Commission has the function under Part 3 of the 2002 Act of determining maximum amounts of charges for services provided by Scottish Water by such time and in respect of such period (the "Review Period") as the Scottish Ministers may specify (the process by which the Commission discharges this function being known as the "Strategic Review of Charges" or "SRC").
- (2) The Commission is required to exercise this function for the purpose of ensuring that (a) Scottish Water's income from charges, taken together with certain other resources, is not less than sufficient to meet the expenditure it requires for the effective exercise of its core functions (which is taken to be the case where Scottish Water makes such use of its resources that it achieves the objectives set for it by the Scottish Ministers (the "Ministerial Objectives") at the lowest reasonable overall cost); and (b) so far as is consistent with (a), any charges scheme made by Scottish Water gives effect to the statement of policy regarding charges issued by the Scottish Ministers in respect of the Review Period (the "Statement of Policy").
- (3) The Scottish Ministers must, before setting the Ministerial Objectives or issuing the Statement of Policy, consult CFS. The Commission must, before determining maximum amounts of charges, invite representations on a draft of its determination from the Scottish Ministers, Scottish Water and CFS.
- (4) The Commission is expecting to receive a letter from the Minister for Infrastructure and Capital Investment (the "Minister") requesting it to undertake a Strategic Review of Charges in respect of the 2015 - 2020 Review Period (the "SRC 2015-20").
- (5) The Commission, Scottish Water and CFS (together, the "Parties") have held a series of discussions in light of the anticipated request from the Minister and have concluded that they should establish a forum (the "Customer Forum") to play a formal role in facilitating effective customer engagement in the context of the SRC 2015-2020.

Now it is agreed as follows

#### 1. Definitions and interpretation

- 1.1 Words and expressions defined in the 2002 Act shall, unless otherwise provided, have the same meaning when used in this Agreement.

## **2. Aims and principles**

- 2.1 The purpose of the Customer Forum is to play a formal role in the SRC 2015-2020 process by:
- 2.1.1 working with Scottish Water on a programme of quantitative and qualitative research to establish customers' priorities for service level improvement and expectations in terms of the level of charges;
  - 2.1.2 understanding and representing to the Commission and to Scottish Water the priorities and preferences of customers (as a whole) in the SRC 2015-2020 process as identified through the customer research; and
  - 2.1.3 seeking to secure, through its participation in that process, the most appropriate outcome for customers (as a whole) based on those priorities and preferences
- in relation to those matters remitted to it by the Commission from time to time, following consultation with Scottish Water and the Scottish Ministers, and in accordance with the timeline set out in Part 4 of the Schedule (as amended from time to time) (the "Timeline") or such other timetable as may be specified by the Commission following consultation with the Customer Forum.
- 2.2 The Customer Forum may undertake such activities as it considers (having regard to the need to keep within its agreed budget) to be necessary or desirable in order to secure its effective and timely participation in the SRC 2015-2020 process and shall, where appropriate, consult with the industry quality regulators, SEPA and DWQR.
- 2.3 The operational activities of the Customer Forum must be consistent with the governance and remit of CFS as the accountable body. This will not detract from the Customer Forum's independent role with regard to the SRC 2015-2020 process.
- 2.4 While respecting the Customer Forum's independence, the Customer Forum will provide quarterly reports on progress against its workplan to CFS for its information and in accordance with CFS' governance arrangements.
- 2.5 The members of the Customer Forum will be accountable to the Parties for ensuring that they act at all times in a manner consistent with the aims and principles set out above and otherwise in accordance with this Agreement.
- 2.6 The Parties undertake to do all such things as may be necessary or desirable for the purpose of giving effect to this Agreement and shall cooperate in good faith with each other and with the representatives of the Customer Forum with a view to securing the aims and principles set out above.

## **3. Constitution and governance**

- 3.1 Unless and until a separate legal entity is formed to take on the role of the Customer Forum, the Customer Forum will not be constituted as a separate legal entity and will consist of a panel of 8 ordinary members and a chairman each of whom will be appointed jointly by the Parties.
- 3.2 The procedure and terms governing the appointment of members is set out in Part 1 of the Schedule.
- 3.3 The members of the Customer Forum will be required to act within the terms of clause 2.1 above. The Customer Forum will have discretion as to how to frame the discussions between the engagement committee and Scottish Water but with reference to the views and opinions obtained from the public generally in consumer research. It is not expected to be involved in policy decisions nor is it intended to be a voice for the community generally in relation to matters outwith the purpose outlined in clause 2.1 above.
- 3.4 The accountable body for the Customer Forum is CFS. Therefore, the Customer Forum will not have power to acquire or lease any property, borrow any sums, engage any employee or enter into any legally binding contracts or other arrangements, or undertake any other operational activity that is not consistent with CFS' administrative policies or procedures.
- 3.5 Resources will be provided to the Customer Forum by the Parties, as set out in clause 5.
- 3.6 The Customer Forum shall work with Scottish Water on a programme of quantitative and qualitative research to establish customers' priorities for service level improvement and expectations in terms of the level of charges from step 2 onwards in the Timeline. If,

## 3

notwithstanding that research programme, the Customer Forum determines that additional research is required, the Customer Forum shall seek to agree with Scottish Water the scope of the additional research which Scottish Water should undertake but, failing agreement, CFS shall, upon request from the chairman, instruct the additional research and the costs of such research shall be paid from, and within the parameters of, the previously agreed Forum Budget.

- 3.7 No member of the Customer Forum shall incur any third party expenses without having a prior, written delegation from the chairman. All such approved third party expenses shall be subject to CFS finance and procurement rules and reimbursed from the Forum Budget administered by CFS. No member of the Customer Forum shall be entitled to be reimbursed any third party expenses which have not had the prior approval of the chairman or which would exceed the balance of funds within the Forum Budget.

#### **4. Engagement committee**

- 4.1 The Customer Forum will form a sub-committee of its members to undertake the role of engaging directly with Scottish Water in accordance with step 8c in the Timeline. The engagement committee will be established and will operate in accordance with the provisions of Part 2 of the Schedule.
- 4.2 After considering and discussing the customer research and the scope of the matters remitted to it by the Commission, the Customer Forum will provide the engagement committee with an initial remit for the engagement with Scottish Water. The Customer Forum may amend or expand the remit at any time. In addition, the Customer Forum may give specific directions to the engagement committee which it must seek to have included in the package agreed with Scottish Water.
- 4.3 If the engagement committee agrees a position with Scottish Water which is within the remit given to the engagement committee by the Customer Forum, then the Customer Forum will automatically approve the agreed position.
- 4.4 If the engagement committee is unable to agree a position that falls within the remit given to it by the Customer Forum, it must go back to the Customer Forum for approval. If the Customer Forum agrees a position then the engagement committee must adopt that position in its discussions with Scottish Water.
- 4.5 If agreement is reached with Scottish Water, the Customer Forum and Scottish Water will prepare a joint report to the Commission setting out the agreed terms as envisaged by step 9 in the Timeline.
- 4.6 If agreement cannot be reached with Scottish Water, the Customer Forum and Scottish Water will endeavour to submit a joint report to the Commission setting out the points in issue and reasons for the disagreement, failing which the Customer Forum and Scottish Water shall be required to submit separate reports to the Commission setting out their view of the points in issue and the reasons for disagreement in accordance with step 9 in the timeline.

#### **5. Resources**

- 5.1 The parties agree that they shall meet the financial liabilities of the Customer Forum and provide additional resources to the Customer Forum as follows:
- 5.1.1 the Commission shall:
- (i) provide the Customer Forum with:
- (i)(a) an annual budget of £175,000 from the Commissions existing agreed annual levy, to meet the expenses of the Customer Forum (the "Forum Budget"). The Forum Budget shall be paid in two equal instalments each year with the first payment made on the date of this agreement and semi-annually thereafter on the six month anniversary of the date of this Agreement, into the CFS bank account where it will be ring-fenced to be administered in accordance with this Agreement. Any part of the Forum Budget not used, shall be retained in the account and shall be available to the Customer Forum in the following six month period in addition to the budget for that period;

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- (i)(b) technical assistance, upon request by the Customer Forum, including any resources necessary to analyse information provided by Scottish Water; and
  - (i)(c) meeting rooms on request by the Customer Forum, at no additional cost to the Forum; and
  - (ii) pay to CFS, an amount not exceeding 20% of the Forum Budget (the "Services Fee") to meet the costs incurred by it in relation to the services to be provided by it to the Customer Forum in accordance with clause 5.1.2 below;
- 5.1.2 CFS shall in return for the payment of the Services Fee:
- (i) provide the Customer Forum with payroll and other banking and accounting functions (including, without limitation, the preparation of monthly management accounts and audited annual accounts);
  - (ii) ensure that such Forum Budget is managed in accordance with the principles of regularity, propriety and value for money observed by CFS in respect of its own affairs;
  - (iii) provide corporate services support in terms of facilities management, information technology (IT), human resources (HR) and senior management; and
  - (iv) provide office accommodation, access to meeting room facilities and general administrative support services.
- 5.1.3 Scottish Water shall:
- (i) provide the Customer Forum with:
    - (i)(a) access to all existing and ongoing customer research in accordance with the agreed research programme;
    - (i)(b) technical assistance upon request by the Customer Forum; and
    - (i)(c) meeting rooms on request by the Customer Forum, at no additional cost to the Customer Forum.
- 5.2 For the avoidance of doubt, direct costs incurred by the Forum shall be covered by the Forum Budget and will include staff costs, programme costs and running costs.
- 5.3 On termination of this Agreement and the disbanding of the Customer Forum, the balance of the Forum Budget remaining after payment of all liabilities properly incurred by the Customer Forum, if any, shall be repaid to the Commission.
- 5.4 Other than the Forum Budget to be contributed annually by the Commission, the Parties shall have no obligation to contribute to the costs or liabilities of the Customer Forum. The liability of the Parties to the members of the Customer Forum shall be limited to the funds representing the balance of the Forum Budget held in the CFS bank account on behalf of the Customer Forum, from time to time.
- 6. Information**
- The Customer Forum shall procure that an audit is undertaken annually and shall provide the Parties with a copy of the results of the audit within 3 months of each anniversary of the date of this Agreement to enable them to be published on the Parties' respective websites if the Parties consider it necessary or appropriate. In addition, the Customer Forum shall provide the Parties promptly with such other information concerning the activities and financial affairs of the Customer Forum as the Parties may reasonably require from time to time to fulfil any statutory obligation to which they are subject.
- 7. Review of terms**
- 7.1 The Parties agree that it may, in due course, be appropriate to incorporate a company limited by guarantee to take over the role of the Customer Forum. If at any time, the Commission, CFS and Scottish Water agree that incorporation is appropriate, the Parties shall take the necessary steps to incorporate a corporate vehicle with a constitution which broadly reflects the rights and obligations of Customer Forum and the Parties as set out in this Agreement (as amended from time to time).

7.2 The Commission and Scottish Water acknowledge and agree that if the CFS considers that it is not able to become a member of the corporate vehicle, they will procure that the corporate vehicle enters into an agreement with the Council substantially in the form of the participation letter set out in Part 3 of the Schedule to ensure the continued involvement of the Council in the SRC 2015-20 process.

7.3 The Parties agree to review the terms of this Agreement no later than two years following the date of this Agreement. In addition, the Parties agree to review this Agreement in good time before any party for any reason ceases to exist in order to ensure the continued operation of the Customer Forum.

#### **8. Termination**

8.1 Subject to clause 8.2, the Customer Forum shall remain in place for such period as is required to facilitate effective customer engagement in the context of the SRC 2015-2020 process.

8.2 Notwithstanding clause 8.1, this Agreement (other than the provisions of clauses 2.4, 5.2, 5.3, 13, 14 and 15) shall terminate and the Customer Forum shall be disbanded upon the later of:

8.2.1 the expiry of the period during which Scottish Water may request the Commission to make a reference to the Competition Commission, step 14 in the timeline, in respect of the determination made by it at the conclusion of the SRC 2015-2020 process; or

8.2.2 in the event that such a request is made in step 14 in the Timeline, the date upon which the Competition Commission reports to the Commission on the reference made by it.

#### **9. Announcements**

Save as otherwise set out in this Agreement, no announcement, circular, advertisement or other publicity in connection with this Agreement, its subject matter or any ancillary matter shall be made or issued by or on behalf of any Party (save as required by law or any governmental or regulatory organisation) without the prior written consent of the other Parties (such consent not to be unreasonably withheld or delayed).

#### **10. Notices**

10.1 Any notice, demand or communication in connection with this Agreement shall be in writing and delivered personally or sent by pre-paid first class post (or airmail if overseas) or by fax to the recipient's address as set out at the beginning of this Agreement or to any other address which the recipient has notified in writing to the sender not less than 7 Business Days before the notice is despatched.

10.2 The notice, demand or communication is deemed given:

10.2.1 if delivered personally, at the time of delivery to the address provided for in this Agreement;

10.2.2 if sent by pre-paid first class post, on the second Business Day after posting it; or

10.2.3 if sent by fax, at the time of transmission;

provided that, if it is delivered personally or sent by fax on a day which is not a Business Day or after 4pm on any Business Day, it shall instead be deemed to have been given or made on the next Business Day.

#### **11. Entire Agreement**

This Agreement and the documents referred to in it, constitute the entire agreement between the parties and supersede and replace any previous agreement, understanding, undertaking or arrangement of any nature between the parties relating to the subject matter of this Agreement, save that nothing in this Agreement shall limit or exclude any liability for fraud.

#### **12. Variation**

12.1 Subject to clause 12.2, this Agreement may only be varied by an agreement in writing signed by or on behalf of each party to this Agreement.

12.2 If a Party ceases to exist the consent of that Party shall not be required for any variation of this Agreement.



**13. Legal Effect**

- 13.1 Nothing contained in this Agreement, and no action taken by the parties pursuant to this Agreement, shall be deemed to constitute a relationship between the parties of partnership, joint venture, principal and agent or employer and employee. None of the parties has, nor may it represent that it has, any authority to act or make any commitments on the other parties' behalf or otherwise bind the other parties in any way.
- 13.2 Nothing in this Agreement shall be construed as limiting or restricting the ability of any of the Parties to exercise any powers or functions conferred on it by or under any enactment, or to perform any duty (including a duty to exercise discretion) imposed on it in relation to any such power or function.

**14. Governing Law**

The formation, existence, construction, performance, validity and all aspects whatsoever of this Agreement or any term of it (including non-contractual disputes or claims) shall be governed by the laws of Scotland.

**15. Dispute resolution**

- 15.1 In the event of any dispute arising out of or in relation to this Agreement, each of the Parties shall use all reasonable endeavours to consult and negotiate with each other, in good faith and, recognising their mutual interests, attempt to reach a settlement of the dispute to the satisfaction of all Parties. Within 7 days of a dispute arising the Parties shall convene a meeting between persons nominated by each Party (the "Appointed Persons") to attempt to resolve the dispute. If the Appointed Persons do not reach a settlement within 7 days of their first meeting, the dispute shall be managed in accordance with clause 16 below.
- 15.2 If the Appointed Persons agree upon a resolution of the dispute, they shall sign a statement setting out the terms of the resolution and the Parties shall use procure that the resolution is fully and promptly carried out.

**16. Expert Determination**

- 16.1 If the Appointed Persons fail to reach a settlement in accordance with clause 15.1, of any dispute that arises out of or in connection with this Agreement, the Parties shall refer the dispute to an Expert for final and binding determination.
- 16.2 The Expert shall be a Chartered Accountant of not less than 10 years' standing and:
- 16.2.1 shall be agreed by the Parties within 7 days of service of the expert determination notice, or
- 16.2.2 in the absence of agreement by the parties, appointed by the President or appropriate officer from time to time of the Institute of Chartered Accountants.
- 16.3 Upon appointment of the Expert, the referring parties shall provide a notice setting out the subject matter of the dispute and the issues he is required to determine.
- 16.4 The Expert shall in his absolute discretion decide the procedure to be adopted to determine the dispute and the timetable for the same, including (to the extent he considers necessary) instructing professional advisers to assist him in reaching his determination.
- 16.5 The Parties shall provide (or procure that others provide) the Expert with all such assistance and documents as the Expert reasonably requires for the purpose of reaching a decision, and are each entitled to make submissions to the Expert including oral submissions. Each Party shall with reasonable promptness supply each other with all information and give each other access to all documentation and personnel as the other party reasonably requires to make its submissions.
- 16.6 The Expert shall have the power to conduct such surveys, tests and investigations as he reasonably believes appropriate or to request further information or submissions from the parties.
- 16.7 The Expert shall make his determination in writing to the parties giving reasons for his determination. In so doing, he shall act as an expert and not as an arbitrator, limiting himself to the issues referred to him and using his professional expertise and experience to make his determination. The provisions of the Arbitration (Scotland) Act 2010 (or any subsequent modification or replacement of that Act) shall not apply. The Expert's determination on the

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matters referred to him shall be final and binding on the parties in the absence of manifest error or fraud.

- 16.8 The Expert may on his own initiative or at the written request of either party, correct any clerical mistake, error or ambiguity within his determination provided that the initiative is taken or the request is made within 3 days of the notification of his determination to the parties. The Expert shall make his corrections within 3 days of any such request.
- 16.9 The Expert shall have the power to determine liability for the costs of the determination, including his fees and any test, investigations or surveys carried out, but excluding legal or other professional costs incurred by the parties, in such proportions as he sees fit.

IN WITNESS WHEREOF these presents consisting of this and the 6 preceding pages and the Schedule consisting of 4 parts have been subscribed as follows:

EXECUTED for and on behalf of THE WATER  
INDUSTRY COMMISSION FOR SCOTLAND

at Edinburgh

on 30/9/11

by Alan David Alexander Sutherland

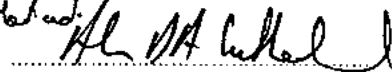
its authorised signatory in the presence of this  
witness:

Witness MARK NOLAN

Full name MARK NOLAN

Address FORBES WAY,

STIRLING



Authorised signatory

EXECUTED for and on behalf of SCOTTISH  
WATER

at Dunfermline

on 30/9/11

by John Douglas Nelson

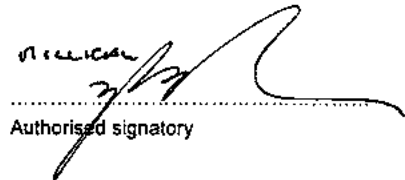
its authorised signatory in the presence of this  
witness:

Witness TRISHA McAULEY

Full name TRISHA McAULEY

Address ROYAL EXCHANGE HOUSE

100 QUEEN ST, GLASGOW, G1 3DN



Authorised signatory

EXECUTED for and on behalf of THE  
NATIONAL CONSUMER COUNCIL

at London

on 28/9/11

by NIKE O'CONNOR

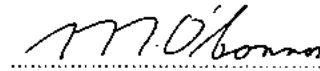
its authorised signatory in the presence of this  
witness:

Witness JEANETTE HARVEY

Full name JEANETTE HARVEY

Address FLEETBANK HOUSE

SANSBURY SQ, LONDON, EC4Y 8TX



Authorised signatory

This is the Schedule referred to in the foregoing Co-operation Agreement among The Water Industry Commission For Scotland, Scottish Water and The National Consumer Council dated 2011

## SCHEDULE

### Part 1

#### Constitution of Forum

#### 1. Appointment of Chair and members

- 1.1 Members will be appointed jointly by Scottish Water, the Commission and CFS, but on the basis of the following nominations procedure:
- 1.1.1 Scottish Water, CFS and the Commission shall jointly nominate an independent chairman, having regard to an appropriately open recruitment procedure;
- 1.1.2 CFS shall nominate 5 persons with a strong customer focussed reputation as ordinary members, and
- 1.1.3 the Commission shall seek nominations for:
- (i) two other ordinary members from the two water services providers and/or sewerage services providers with the largest market shares of the water services and/or sewerage services markets (the "Retailers"); and
- (ii) one other ordinary member from the Scottish Council of Development and Industry ("SCDI").
- The persons nominated shall be appointed by the Parties, and there shall be no ability for any Party to veto the appointment of any person so nominated provided that such persons fulfil the criteria set out at paragraph 1.2 below. The members shall hold office in their personal capacities and not as a representative of the person(s) who nominated them.
- 1.2 The Chair and Members must satisfy the following criteria:
- 1.2.1 they must not hold a political office or be standing as a political candidate for election at any level;
- 1.2.2 they must not have any criminal convictions;
- 1.2.3 they must not have been disqualified from acting as a director;
- 1.2.4 they must be prepared to engage constructively in the process outlined in clause 2.1 of the Agreement in a personal capacity without representing any political interests; and
- 1.2.5 they must not be an employee or board member of, or otherwise be engaged by, Scottish Water, CFS or the Commission.
- 1.3 The chairman shall also be the chairman of the engagement committee.
- 1.4 If a chairman is appointed who is already an existing ordinary member, they shall vacate that existing position and the entity which originally nominated the person to be an ordinary member pursuant to paragraph 1.2 above shall be entitled to nominate someone else in his place as an ordinary member.
- 1.5 The ordinary members and the chairman shall be appointed for such period as is required to complete the SRC 2015-2020 process.
- 1.6 In line with CFS' governance arrangements the Chair and members will be subject to an annual appraisal of performance in respect of their Customer Forum duties. For the Chair of the Customer Forum, this appraisal will be held with the Chair of CFS. For the Customer Forum members, this appraisal will be held with the Customer Forum Chair.
- 1.7 Notwithstanding paragraph 1.2 above:
- 1.7.1 the appointment of the chairman and each ordinary member will automatically terminate:
- (i) if the Agreement is terminated; or
- (ii) if a separate legal entity is established to take on the role of the Customer Forum;
- 1.7.2 the appointment of the chairman may be terminated by a unanimous decision of the Parties on the grounds of:
- (i) misconduct;

- (ii) being incapable over a period of four weeks of more of discharging their responsibilities and duties as chairman due to illness or other cause;
  - (iii) insolvency;
  - (iv) failure to fulfil the criteria set out in paragraph 1.2 above; or
  - (v) any action that has brought the Customer Forum or CFS into disrepute.
- 1.7.3 the appointment of an ordinary member nominated by CFS may be terminated at the discretion of the Commission and CFS on the recommendation of the chairman on the grounds of:
- (i) misconduct;
  - (ii) being incapable over a period of four weeks of more of discharging their responsibilities and duties as an ordinary member and/or member of the engagement committee (as the case may be) due to illness or other cause;
  - (iii) insolvency;
  - (iv) failure to fulfil the criteria set out in paragraph 1.2 above; or
  - (v) any action that has brought the Customer Forum or CFS into disrepute.
- and CFS shall be entitled to nominate another ordinary member in their place; and
- 1.7.4 the appointment of an ordinary member (other than one nominated by CFS) may be terminated at the discretion of the Commission on the recommendation of the chairman on the grounds of:
- (i) misconduct;
  - (ii) being incapable over a period of four weeks of more of discharging their responsibilities and duties as an ordinary member and/or member of the engagement committee (as the case may be) due to illness or other cause;
  - (iii) insolvency;
  - (iv) failure to fulfil the criteria set out in paragraph 1.2 above; or
  - (v) any action that has brought the Customer Forum or CFS into disrepute.
- and the party responsible for the original nomination of the ordinary member concerned shall be entitled to nominate another ordinary member in their place.
- 1.8 If the chairman resigns a new chairman will be appointed pursuant to paragraph 1.1.1 and paragraph 1.2 above.
- 1.9 If an ordinary member resigns a new member will be appointed by the entity which originally nominated the person to be an ordinary member pursuant to paragraph 1.2 above.
- 2. Remuneration**
- 2.1 The chairman shall:
- 2.1.1 be paid a daily rate as agreed by each of the Parties for services provided, which rate shall be broadly consistent with the Scottish Government's Chair and Members Daily Fee Framework for similar positions in Band 3;
  - 2.1.2 be entitled to reimbursement of properly incurred expenses in line with the CFS travel and expenses policy upon submission of the relevant receipts to the CFS; and
  - 2.1.3 be required to work an average of up to 90 days per year over his term in office it being recognised that in certain years the chairman may be required to provide fewer or greater than the average number of days.

- 2.2 Ordinary members that are not employees of, board members of, or otherwise related to, or engaged by CFS, the Retailers or SCDI shall:
- 2.2.1 be paid a daily rate as agreed by each of the Parties for services provided, which rate shall be broadly in line with the Scottish Government's Chair and Members Daily Fee Framework for similar positions in Band 3; and
- 2.2.2 be entitled to reimbursement of properly incurred expenses, which have been approved in advance by the chairman, in line with the CFS travel and expenses policy upon submission of the relevant receipts to the CFS.

### **3. Meetings**

- 3.1 The Customer Forum shall be entitled to decide how to regulate its affairs, including participating in meetings by telephone or video conference, but will be required to meet in person not less than once every quarter.
- 3.2 On request, CFS, Scottish Water and/or the Commission will make available an appropriate meeting room for the Customer Forum meetings.
- 3.3 Unless otherwise agreed by all members of the Customer Forum all members must be given not less than 14 days notice of any meeting and the notice must include details of the business to be discussed at that meeting.
- 3.4 All members of the Customer Forum will be entitled to receive copies of the minutes of each meeting and the papers tabled at each meeting.
- 3.5 Any matter which could be determined at a meeting of the Customer Forum, may be validly determined if approval of the matter is given in writing (including by email or other form of electronic communication) by the percentage of members that would have been required to approve the matter had it been determined at a meeting.
- 3.6 Members of the Customer Forum will be required to keep any information which they obtain or receive as a result of their participation in the Customer Forum and the content of all minutes and all such other papers together with the terms of the remit given to the engagement committee and the discussions leading to the agreement of that remit, confidential and will not be entitled to pass any such information to the person who appointed them without prior approval of the chairman. A breach of this restriction will entitle the defaulter to be removed from the Customer Forum.
- 3.7 Subject to paragraph 3.8, the chairman will ensure that copies of all minutes and any associated papers shall be delivered to each of the Parties to enable them to be published on their respective websites not later than 3 months after the date of such minutes.
- 3.8 The obligation to deliver copies of minutes and associated papers within three months of the date of the relevant minutes shall not apply during the period in which the engagement committee is in active engagement with Scottish Water and all minutes and papers relating to that period shall instead be delivered to the Parties as soon as reasonably practicable after the later of (i) expiry of the period during which Scottish Water may request the Commission to make a reference to the Competition Commission in respect of the determination made by it at the conclusion of the SRC 2015-2020 process; and (ii) in the event that such a request is made, the date upon which the Competition Commission reports to the Commission on the reference made by it.

### **4. Quorum**

The quorum for meetings of the Customer Forum shall be five (unless fewer than five members have been appointed in which case all of the members shall be required for a quorum) and must, include the chairman and at least one member nominated by CFS and one member nominated by either the Retailers or SCDI, provided that if at any meeting a quorum is not present it will be adjourned to the same time and place 7 days later, and if at the adjourned meeting a quorum is still not present it will be adjourned again to the same time and place 7 days later at which time those members in attendance will constitute a quorum.

### **5. Voting**

- 5.1 Members will have one vote each at Customer Forum meetings.
- 5.2 Decisions of the Customer Forum will require the approval of at least 75% of the Customer Forum members present at the meeting.

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5.3 The cheirman shall have a casting vote in the event of deadlock.

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**SCHEDULE****Part 2****Engagement committee**

1. The engagement committee will have a minimum of two and maximum of three members, each of whom must be a Forum member, one of whom must be the chairman, one of whom must have been nominated by CFS pursuant to paragraph 1.1.2 of Part 1 of the Schedule and one of whom must have been nominated by either the Retailers or SCDI pursuant to paragraph 1.1.2 of Part 1 of the Schedule. The Customer Forum shall take steps to procure that all three members are appointed to the engagement committee as soon as possible after the date of this Agreement.
2. The initial member of the engagement committee shall be such person as is appointed as the initial chairman of the Customer Forum and the chairman shall select the remaining members, which selection shall then require the approval 75% of the members of the Customer Forum.
3. The members of the engagement committee (other than the chairman) may be changed at any time by the Customer Forum in accordance with the procedures in paragraph 2 above on the chairman giving not less than three months written notice of the proposed changes to Scottish Water (or such lesser period as Scottish Water may agree from time to time).
4. Notwithstanding the provisions of paragraphs 1 and 3 above, if at any time the engagement committee has less than three members, the engagement committee shall be entitled to continue to engage with Scottish Water for a period of two weeks pending the appointment of additional committee members. The engagement committee shall not be entitled to engage with Scottish Water at the end of that two week period if additional members have not been appointed by that time, until such time as an additional member is so appointed. No notice shall require to be given to Scottish Water of the appointment of any such additional committee members, whose appointment shall be effective immediately upon approval being given by the members of the Customer Forum in accordance with paragraph 2 above.
5. Any member of the engagement committee who ceases to be a member of the Customer Forum for any reason shall automatically cease to be a member of the engagement committee.
6. Decisions of the engagement committee will require unanimity, with each member of the committee having one vote.

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**SCHEDULE**  
Part 4  
Timeline for SRC 2016-20

Step	When	Description
<b>1</b>	Autumn 2011	<p><b>Scottish Government (SG) issues commissioning letter</b></p> <p>The Scottish Government issues a commissioning letter that initiates the next Strategic Review and sets out the broad arrangements to be followed.</p>
<b>2</b>	Autumn 2011	<p><b>Water Industry Commission for Scotland (WICS), Consumer Focus Scotland (CFS), Scottish Water (SW) and SG establish customer forum</b></p> <p>Once the customer forum is established, customer engagement becomes an integral part of the regulatory framework.</p> <p>The date of September 2011 is dependent on the establishment of the CF in sufficient time for its involvement in decisions on the scope of potential options. These decisions will need to be made by the end of January 2011.</p> <p>Scottish Water and the Customer Forum should engage in the Strategic Review process at an early stage. This will ensure that customers' interests are taken into account by Scottish Water as it develops its strategic vision and business plan.</p> <p>On an ongoing basis Scottish Water and the Customer Forum should agree priorities for customer service improvements and the timetable for these to be delivered.</p> <p>The customer forum is expected to draw on the technical expertise of the quality regulators when required. For example, the customer forum could ask the Scottish Environment Protection Agency (SEPA) and the Drinking Water Quality Regulator (DWQR) for clarification on the policy for improving the quality of the environment and drinking water respectively.</p>



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3	31 Jan 2012	<p><b>SG issues principles of charging and objectives</b></p> <p>The draft principles of charging and objectives, based on the statutory elements of Q&amp;S4, will take account of the advice provided to the Scottish Government by SEPA and DWQR.</p> <p>The Scottish Government could use the customer forum as a way to consult customers about the draft principles of charging and objectives for the industry.</p>
4	14 Feb 2012 to 20 Apr 2012	<p><b>WICS provides preliminary view on regulatory inputs</b></p> <p>The regulatory inputs will include, for example, the scope for efficiency, financial strength, prospects for capital and operating expenditure, baseline costs and service.</p> <p>The preliminary view may take the form of general reflections to help guide Scottish Water in developing its strategic vision and business plan.</p> <p>WICS would issue these reflections over a period of time following joint working with Scottish Water.</p>
5	19 Sept 2012	<p><b>SW issues draft 25-year strategic vision</b></p> <p>The vision should include Scottish Water's views on what are acceptable levels of price and service and on the key regulatory inputs.</p> <p>Following discussions with the Customer Forum, Scottish Water would provide an analysis of the priority to be given to improvements in customer service. It would also set out its longer term ambitions for customer service and a transition plan detailing the resources and time necessary to deliver these.</p>
6	12 Dec 2012	<p><b>SG, WICS, customer forum and all other interested stakeholders provide comment on Scottish Water's 25 year strategic vision</b></p> <p>During this period comments would be welcome from all interested stakeholders.</p>

7	30 Oct 2013	<p><b>SW issues final strategic vision and business plan</b></p> <p>The business plan should be presented as Scottish Water's initial view on how best to proceed. It should deal with two aspects:</p> <ul style="list-style-type: none"> <li>- The first should cover baseline levels of service (with an assumption that current level of service and expenditure is a reasonable starting point) and statutory investment requirements.</li> <li>- The second should cover discretionary customer service improvements identified by Scottish Water and the Customer Forum (and based on the engagement process initiated at step 2).</li> </ul> <p>The baseline level of service is the current levels of service at a given point in time. The statutory investment requirements is the outcomes that the Scottish Government decides is necessary to meet European Commission (EC) directives and UK and Scottish legislative requirements<sup>1</sup>. This includes most of the investment needed to improve the environment and the quality of drinking water. Furthermore, the Scottish Government may determine the level of new demand that Scottish Water is to provide for over the period.</p> <p>The discretionary customer service improvements refer to all other investment that has a direct impact on the overall customer experience. This is an area that customers could be expected to influence<sup>2</sup>. There could also be discussions around other, non-investment, areas of the overall customer experience<sup>3</sup>.</p> <p>The business plan should include clear information on the following:</p> <ul style="list-style-type: none"> <li>- The cost of delivering baseline levels of service.</li> <li>- The investment necessary for Scottish Water to deliver its statutory requirements. Scottish Water should also provide confirmation that its proposed approach would deliver the outcomes required by SEPA and the DWQR.</li> <li>- Any benefits to service levels that accrue as a result of investment to satisfy environmental or public health objectives.</li> </ul> <p>Investment area appraisals should be included as an appendix. These should provide the information necessary to enable discussions about any potential alternative, more sustainable or innovative, solutions. Such alternatives could have impacts on the cost, timing and level of compliance; this information will therefore be important in helping the different regulators formulate their responses to individual proposals.</p> <p>The second part of the business plan should set out broad indications of:</p> <ul style="list-style-type: none"> <li>- the level of service that Scottish Water and the Customer Forum think should be being provided to customers;</li> <li>- the gap between that level of service and current performance and improvements resulting from the statutory investment requirements;</li> <li>- the level of resources that Scottish Water and customers think should be spent on discretionary customer service improvements;</li> <li>- the maximum price impact that customers could consider reasonable; and</li> <li>- customers' priorities, as identified through customer research.</li> </ul> <p>The business plan should also highlight any opportunities for innovation or for approaches that will deliver good returns over the longer term.</p>
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<sup>1</sup> For example, this could cover areas such as the water environment, climate change, health and safety, security, public health, highways, etc.

<sup>2</sup> In previous price reviews this has included investment to improve water pressure, improve security of supply to customers, reduce interruptions to supply, reduce the number of sewer flooding incidents (both external and internal), reduce odour at wastewater treatment works, increase capacity at customer contact centres, improve responsiveness to customers, provide water efficiency appliances and advice, protect assets from flooding risk etc.

<sup>3</sup> This could include the customer response strategy, compensation policy, telephone contact hours, the handling of complaints and the provision of information to customers etc.

<p><b>8a</b></p>	<p>13 Dec 2013 to 27 Mar 2014</p>	<p><b>WICS issues discussion papers</b></p> <p>These papers would cover both aspects of Scottish Water's business plan and inform the tri (quinti)-partite<sup>4</sup> meetings between WICS, Scottish Water and customers.</p> <p>They would also inform engagement between Scottish Water and the Customer Forum when the scope and priorities of discretionary customer service improvements are discussed and finalised. At this stage it would also be an aim to draw up a prioritised list of additional improvements, these could be included in the determination if there is scope to do so while maintaining charges at levels considered tolerable by the Consumer Forum.</p> <p>WICS would issue these papers over a period of time. In practice, this means that the tri (quinti)-partite meetings and process of customer engagement could start two weeks after the first discussion paper is published and come to an end three weeks after the last discussion paper is published.</p> <p>The tri (quinti)-partite meetings and discussions between Scottish Water and the Customer Forum would run in parallel. They are outlined in more detail below.</p> <p>Scottish Water (and the quality regulators) would have an opportunity to review the discussion papers for factual accuracy before they are distributed to participants in these meetings.</p>
<p><b>8b</b></p>	<p>10 Jan 2014</p>	<p><b>WICS, SW, customer forum, SEPA and DWQR start tri (quinti)-partite meetings</b></p> <p><u>The tri (quinti)-partite meetings between WICS, Scottish Water and the Consumer Forum</u></p> <p>Scottish Water, WICS and the Customer Forum would participate in tri-partite meetings covering the first part of Scottish Water's business plan. This is the section covering the cost of delivering baseline levels of service. There would be further meetings on the delivery of the statutory investment requirements that would involve the DWQR and SEPA.</p> <p>The meetings would not seek to question the required outcome but could consider, for example, the scope and efficacy of approach set out in the investment areas appraisals and, in certain circumstances, the timing of delivery.</p> <p>The series of papers provided by WICS will be discussed at the meetings. These papers will indicate the position WICS is minded to adopt at the draft determination. There would be an opportunity for Scottish Water (and the quality regulators) to respond to the discussion papers. The meetings may lead to Scottish Water and the Customer Forum proposing different but mutually satisfactory outcomes regarding levels of service to customers.</p> <p>Proposals to adopt innovative or longer term pay-back options would be discussed and agreed. WICS would comment in a discussion paper on the approach taken by Scottish Water in realising the potential benefits of this change to the regulatory framework.</p> <p>The Scottish Government may choose to be involved in this process of discussion or may consider that it should not participate, given its responsibility for framing the objectives for Scottish Water. This is a matter for the Scottish Government to decide.</p>

<sup>4</sup> The Quality Regulators, the Scottish Environment Protection Agency (SEPA) and Drinking Water Quality Regulator (DWQR), could be involved in discussions to confirm the outputs required and whether the scoping of solutions to deliver these outputs appear reasonable

8c	10 Jan 2014	<p><b>SW and customer forum start customer engagement</b></p> <p><u>Engagement between Scottish Water and the Customer Forum to finalise the level of discretionary customer service improvements</u></p> <p>Scottish Water and the Customer Forum would participate in discussions on the second part of Scottish Water's business plan. At this stage, Scottish Water and the Customer Forum would finalise the level of resources as set out in Scottish Water's business plan.</p> <p>Scottish Water and the Customer Forum will then provide further definition around the broad areas for customer improvements based on the customer research and the analysis of the gap between the current level of service across the country and the agreed targeted level of service. This should include both parties agreeing on the criteria for prioritisation of investment and the phasing of outcomes.</p> <p>It should be explicitly recognised that there could be scope for changes in the timing or delivery of projects. In this regard, it may, for example, be useful for Scottish Water and the Customer Forum to develop the clear criteria by which expenditure to deal with issues such as odour mitigation, sewer flooding or security of supply should be prioritised. These criteria could then be published on respective websites.</p> <p>The discussion papers would provide information to the Customer Forum in respect of the efficiency of solution proposed by Scottish Water to deliver these improvements. The Customer Forum could ask WICS for further information if required.</p>
9	15 Apr 2014	<p><b>WICS, SW, customer forum, SEPA and DWQR end tri (quint)-partite meetings and customer engagement</b></p> <p>There would be little flexibility in the deadline for the conclusion of this part of the process. At the end of this process, the Customer Forum and Scottish Water would jointly prepare a document that sets out the areas on which they had agreed and any remaining issues of difference. The Customer Forum and Scottish Water may choose either jointly or separately to set out why they have not been able to agree on a way forward.</p> <p>WICS would take this/these document(s) into consideration in reaching its initial conclusions in its draft determination. The Customer Forum would continue to work with Scottish Water and WICS in monitoring progress in delivering the agreed levels of service.</p>
10	24 June 2014	<p><b>WICS publish draft determination for consultation</b></p> <p>WICS sets out its preliminary view of the price profile consistent with the lowest reasonable overall cost of delivering baseline levels of service, the statutory investment requirements, financially sustainable innovations and initiatives, and discretionary improvements to customer service.</p>

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<b>11</b>	16 Sept 2014	<b>SG, SW, customer forum and all other interested stakeholder provide representations on the draft determination</b> During this period representations would be welcome from all interested stakeholders.
<b>12</b>	30 Sept 2014	<b>SG publishes final objectives, principles of charging and technical expression</b> Ministers would need to decide whether or not to confirm and include the customer service priorities, as agreed between Scottish Water and the customer forum, in their final objectives and principles of charging for the industry.
<b>13</b>	26 Nov 2014	<b>WICS publish final determination</b> WICS sets out its final view on the price profile consistent with the lowest reasonable overall cost of delivering baseline levels of service, the statutory investment requirements, financially sustainable innovations and initiatives, and discretionary improvements to customer service
<b>14</b>	26 Jan 2015	<b>SW decides whether to accept final determination</b> Scottish Water decides whether or not to accept the final determination or to require WICS to refer it to the Competition Commission.
<b>15</b>	27 Mar 2015	<b>SW publish delivery plan</b>

## Letter from Commission Chief Executive to Chair of the Customer Forum



Date: 15 October 2012

Peter Peacock  
Chair  
Customer Forum  
Birchwood  
Newlands of Clans  
Loch Flemington  
Inverness IV2 7QR

Dear Peter

Alex Neil, the Scottish Government's Cabinet Secretary for Infrastructure and Growth, recently wrote to Professor Gordon Hughes, Chairman of the Water Industry Commission for Scotland, to initiate the next Strategic Review of Charges.

I am writing to you now in your capacity as Chairman of the Customer Forum. As you know, the purpose of the Customer Forum is to play a formal role in the Strategic Review process by:

- working with Scottish Water on a programme of quantitative and qualitative research to establish customers' priorities for service level improvement and expectations in terms of the level of charges;
- understanding and representing to the Commission and to Scottish Water the priorities and preferences of customers (as a whole) in the Strategic Review of Charges 2015-20 process as identified through the customer research; and
- seeking to secure, through its participation in that process, the most appropriate outcome for customers (as a whole) based on those priorities and preferences.

We would like you to seek to agree by April 2014 a Business Plan for delivery by Scottish Water in 2015-20. Such a Business Plan should be fully consistent with

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Chairman Professor Gordon Hughes

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Ministerial Objectives and with the views and ranges that the Commission will set out in notes and papers over the period to early 2014, unless there are demonstrable reasons for going outside those ranges to the benefit of customers.

I am now writing to provide more information about issues that may be of particular relevance for the Customer Forum in its discussions with Scottish Water.

As you know, the Water Services etc. (Scotland) Act 2005 established the governance framework for the water and sewerage industry in Scotland. The Scottish Government sets the frequency and timetable for each Strategic Review of Charges. It also determines the high-level environmental, quality and customer service objectives that Scottish Water must deliver. The Commission is then required to establish the lowest reasonable overall cost at which these objectives should be delivered.

The Scottish Government also sets out the charging principles it considers should be followed in deciding the tariffs paid by customer groups for specific services. It also identifies the amount of borrowing the Government will make available to the industry and the level of cross-subsidies between groups of customers it considers appropriate.

Under the 2005 Act, the Commission determines charges within this policy framework. It has no remit to challenge the policy objectives.

However, as the Scottish Government's objectives are defined as outcomes, there is scope to challenge the way that Scottish Water proposes to achieve these outcomes. In particular, there may be scope for the outcome to be delivered later in the regulatory control period or in a way that is different from the approach initially proposed by Scottish Water.

After we publish our discussion papers in late 2013/early 2014, the Customer Forum may wish to explore, in discussion with the environmental and water quality regulators, how Scottish Water has decided what needs to be done in order to meet the objectives set out by the Scottish Government and the associated costs of this activity. Discussions may also extend to any customer priorities and preferences for expenditure beyond those mandated outcomes, as well as the cost challenge on those discretionary outcomes.

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**Chairman** Professor Gordon Hughes

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In order to assist these discussions I have provided more information about key areas that the Customer Forum may wish to consider, the notes and papers that will be provided by the Commission, and about the Strategic Review process itself. This information is set out in the following appendices to this letter:

Appendix 1 outlines the key areas that the Customer Forum may wish to take into consideration during discussions with Scottish Water. To assist the Customer Forum we plan to produce detailed papers about each of these key areas. Appendix 1 also includes information about when we will publish these papers. Our views on these key areas will be updated in the discussion papers that we will publish on Scottish Water's Business Plan, and these will assist the Customer Forum in the process of reaching agreement with Scottish Water on its Business Plan.

Appendix 2 provides an outline of the steps that we consider are most relevant for the work of the Customer Forum.

Appendix 3 is the timeline of the Strategic Review of Charges process.

This letter and appendices are intended to bring helpful clarity to the process and are not intended to limit the ability of the Forum to reasonably ask questions and seek justifications on matters they believe should be pursued in the customer interest as the process unfolds.

We look forward to working with you and the other members of the Customer Forum to ensure that customers in Scotland continue to receive high-quality, value for money water and sewerage services.

Yours sincerely

Alan Sutherland  
Chief Executive

*Cc Douglas Millican, Scottish Water  
Trisha McAuley, Consumer Focus*

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## Covering letter from Chair of the Customer Forum to the Commission, 30 January 2014



Alan Sutherland  
Chief Executive  
Water Industry Commission for Scotland  
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Moray House  
Forthside Way  
Stirling  
FK8 1QZ

30<sup>th</sup> January 2014

Dear Alan

### **Minute of Agreement on Scottish Water Draft Business Plan 2015-2021 between the Customer Forum and Scottish Water – January 2014**

I write in my capacity as Chair of the Customer Forum and in formal response to your letter to me of 15<sup>th</sup> October 2012 in which you invited the Customer Forum “to seek to agree by April 2014 a Business Plan for delivery by Scottish Water in 2015-20 (Note: subsequently changed to 2021). Such a Business Plan should be fully consistent with Ministerial Objectives and with the views and ranges that the Commission will set out in notes and papers over the period to early 2014..”.

That letter reflected priorities from the Scottish Government to the Commission set out in a letter of 13 June 2012 which, inter alia, advised the Commission that in the Strategic Review of Water Charges: 2015-21, “Ministers support the aspiration to increase and improve customer involvement in the setting of investment priorities to deliver the levels and quality of service they deserve for the charges they pay. They expect Scottish Water and its regulators to assist fully in the work of the Customer Forum.”

I am pleased to be able to formally advise you that the Customer Forum and Scottish Water have reached agreement on the Scottish Water Business Plan for the period 2015-21. That agreement meets the terms of the remit given to us, and both the spirit and specific terms of the guidance set out in – Strategic Review of Charges 2015-21: Innovation and Choice. Further, the agreement fits within the parameters established through the 22 Information Notes issued by the Commission, and, I believe, meets Ministerial objectives as they have been set out to the Customer Forum. The agreement reached is represented by the attached Minute of Agreement and dated 30 January 2014 signed by myself and the Chief Executive of Scottish Water, setting out the modifications to the draft business plan published by Scottish Water on 30<sup>th</sup> October 2013. The Customer Forum considers the Minute of Agreement represents a positive outcome for customers which also allows Scottish Water to deliver continuing improvements in service in the coming period.

While the formal position is as set out in the immediately preceding paragraph it may be helpful to the Commission to have a further description of the process through which agreement has been reached. What follows has been agreed as a fair representation of the matters covered, by Scottish Water.

The Strategic Review of Charges 2015-21: Innovation and Choice, sought to establish an iterative process between Scottish Water and its customers, as represented by the Customer Forum. Over the period since the autumn of 2011 the Customer Forum and Scottish Water have met formally on some 27 occasions (21 Full Forum, 6 Engagement Committee), in addition there have been briefings and a

number of informal liaison meetings between me as Chair of the Customer Forum and the Chief Executive of Scottish Water, and the Forum met the full Board of Scottish Water informally on one occasion and I have met informally with the Chair of Scottish Water on at least one occasion. Throughout the iterative process, as you are aware, I have made a point of keeping in touch with you as Chief Executive of the Commission in order to advise you of emerging issues and the desired direction of travel of the Forum, in order to ensure the Forum was not straying beyond any parameters set and that our considerations were appropriate. I have further met formally with Consumer Futures on two occasions, and further with them and all the sponsors of the Forum on at least another two occasions. I have sought to keep Scottish government officials regularly informed of progress on a similar basis to the discussions I have had with you. The Forum has participated in the formal quinti-partite meeting called by the Commission between all the relevant stakeholders to the process on the matter of the Scottish Water draft business plan.

In addition, the Customer Forum has: discussed methods of approach with Prof. Stephen Littlechild and Harry Bush – both experienced in deeper customer engagement within regulatory settlements at the UK and international level; sought the formal help of the Independent Assessor on one occasion and sought advice on particular issues from him informally on a number of occasions; held bi-lateral discussions with each of the DWQR, SEPA, and Scottish Public Service Ombudsman office; briefed the relevant Parliamentary Committee Convener and Committee Clerk on Customer Forum objectives and activities on two occasions; briefed MSPs on one occasion; met with the Convention of Scottish Local Authorities on two occasions; met with the Innovation Panel appointed by the Commission on one occasion; and met with the serving Minister for Infrastructure on two occasions to brief them of Forum objectives and progress. I believe the significant liaison activities above have contributed to informing the Forum's activities and in also keeping key stakeholders informed.

The iterative process envisaged between Scottish Water and the Customer Forum has worked well and it has been conducted in a very constructive and professional manner, for which I give significant credit to Scottish Water, particularly as not all the messages we have been giving have been comfortable for them to receive. Scottish Water has almost invariably been represented at Finance Director or Chief Executive level in the discussions and the commitment of the Chief Executive and his Board to a serious dialogue with customers has been evident throughout. It is also apparent to us that the matters we have raised in discussions have been listened to and, where achievable, Scottish Water has actively sought to accommodate the Forum's views and aspirations.

As the relationship between the Customer Forum and Scottish Water has developed and strengthened over the period it is clear we have been on a journey of exploration involving a significant depth of engagement on a wide range of issues and as a consequence, potential initial approaches to issues we have explored and discussed have matured, evolved and developed, giving rise to the propositions Scottish Water made in their draft business plan. I believe it would be fair to characterise the engagement as one in which shared positions have emerged from a process involving, a company with a high degree of professional expertise and commitment to delivering ever improving customer services, and keen to actively seek out and hear to customer views, engaging with an ever more informed Customer Forum equally keen to assert customer interests and priorities in the price setting process.

Further, I believe the ongoing role played by the Commission in the form the various inputs of staff, and principally by you as Chief Executive in helping bring Scottish Water and the Customer Forum towards a point of common agreement, has been crucial.



In consequence, the process of iterative discussions between the Customer Forum and Scottish Water allowed Scottish Water to come forward with a Draft Business Plan which they made clear attempted to be as close to 'near final' as they could achieve by the stage it was published. Indeed, the process established meant it was really not possible to come forward with anything other than a near final draft business plan, as all the components of the business plan had been visible and subject to detailed discussion throughout the process. There was very little in the Draft Business Plan which was not anticipated and there were a number of areas where the research findings and the input of the Customer Forum, and the willingness of Scottish Water to hear what the Customer Forum was saying, has resulted in an evolving emphasis and priority being given to important issues like sewer flooding, the question of the customers' experience of water pressure and visible leakage, and price issues, for example. There has also been a welcome evolution of the central role customers can play in ongoing dialogue throughout a settlement period, and not just every time there is a price review. The draft business plan of course sits firmly within the framework of the longer term Strategic Projections produced and consulted on by Scottish Water and upon which the Customer Forum formally commented to Scottish Water. The process we have worked through with Scottish Water breaks down into what are five distinct phases, following the initial familiarisation of the Customer Forum with the company and its priorities and performance.

Phase one involved significant customer research undertaken principally by Scottish Water, with input as to content and conduct from the Customer Forum. The Customer Forum also commissioned its own research specifically to explore affordability and willingness to pay issues. Further the Customer Forum commissioned reports on the effects of the enduring difficult economic circumstances on household incomes, and advice on issues around the use of RPI and CPI as measures of inflation, from an independent academic source. In addition, the Customer Forum commissioned a report on the significant benefit and tax credit changes that have been being implemented, to understand their impact on household incomes. Most importantly, arising from the research undertaken by Scottish Water, the Customer Forum and Scottish Water formally agreed what that research was telling us about customer priorities for investment and customer service. That agreement is represented within the concluding report on the research in the publication 'Listening to Our Customers' published by Scottish Water. All of the research material referred to above is publicly available on the Scottish Water and Customer Forum websites.

Phase two involved the Customer Forum receiving eight detailed Service Improvement Reports (SIRs), copies of which were made available to the Commission and relevant other regulators at the time. The SIRs were essentially reports on aspects of service and the need for expenditure which would form the detailed component parts of what would make up the core of the Scottish Water business plan. Importantly, each of the service improvement reports referred back to the customer research referred to above and the agreed priorities for investment arising, as one important part of the considerations, thus linking the customer research directly to the investment considerations. Each SIR was the subject of detailed discussion between the Customer Forum and Scottish Water, typically for a couple of hours on each report. Where at the end of those discussions the Customer Forum still had outstanding questions or points to make, those were followed up briefly in writing and Scottish Water either reported back to the Forum on those matters, or they were accounted for in the evolving positions referred to above. One specific discussion concerned discretionary elements of potential spending which were worked through and specifically amended and agreed, and which then formed part of the draft business plan.

The third phase concerned the work to publish the draft business plan and where the Forum was involved in discussions through seeing a draft draft plan. The draft business plan published, because of

the discussions referred to above, in effect, already contained a significant level of agreement already reached between the Customer Forum and Scottish Water through the iterative process.

The fourth phase, subsequent to the publication of the draft business plan, involved the Customer Forum considering its response. As stated above, there were very few surprises in the plan because of the nature of the plan development process so, for example, the key investment priorities were as we had understood they would be following the discussion on the SIRs. The Forum regarded the plan as 'near final', but still capable of potential further improvement. The Forum set out for Scottish Water a detailed response to the plan, signalling areas in which it sought further discussion. These further 'fields for engagement' (below) became the agenda for the final phase:

- Investment levels and priorities (resilience issues)
- Tramlines
- Performance measurement
- Customer engagement
- Business customers
- Price Promise and Guaranteed Standards of Service
- Communication and supply pipes.
- Customer education and care.
- Support to the most vulnerable customers.
- Framing the long term view of improved customer services.
- Prices.

The fifth and final phase was slightly different in character to all the phases up to this point, taking the form of a negotiation on some matters of principle, and some of detail. The Customer Forum, as required by the terms of the agreement establishing it, had appointed members to an Engagement Committee, comprising myself and two other Customer Forum members. The Scottish Water members comprised the Chief Executive and two other senior colleagues. The Engagement Committee met on three separate occasions and for around 12 hours of very detailed discussion, to agree on issues and what has become the attached Minute of Agreement. It is important to stress that throughout the entirety of the process both parties have sought not to characterise the discussions as 'win or lose'. Even in this negotiating phase, which benefited considerably in my view from the relationships built through the engagement over the preceding couple of years, the character was one of better understanding ambitions and perspectives, from which agreed positions emerged.

As you are aware, the Engagement Committee met immediately at the conclusion of the last phase with you as Chief Executive of the Commission to set out where we had got to in our discussion and what we had concluded, and to ensure there was nothing that we had done or had failed to do that would require us to have further discussion.

I believe the process that the Commission established for this price review, with the active support of the Scottish government and other key stakeholders, has given rise to a considerable empowerment of customer interests at the heart of the price setting process. That has been principally achieved by the invitation to the Customer Forum and Scottish Water to seek to agree the business plan, giving focus and real power to the process. I also believe the fact that the Customer Forum was independent of all the key stakeholders, and has no statutory powers in relation to Scottish Water, considerably facilitated the ability of both parties to openly share emerging thinking. The process established has also resulted in what appears earlier and more detailed consideration of a wide range of service improvement issues, and



transparency to customers and the Commission that would not have been so apparent in previous price review procedures.

I have pleasure in now attaching for the consideration of the Commission the agreed position between customers, as represented by the Customer Forum, and Scottish Water, in the attached Minute of Agreement. The Customer Forum hopes the agreement provides the basis for the Commission's considerations toward preparing the determination of charges and for Ministers to finalise the Principles of Charging and final Ministerial Objectives.

Yours sincerely

Peter J Peacock  
Chair  
Customer Forum

CONFIDENTIAL

## Scottish Water and the Customer Forum: Minute of Agreement

### SCOTTISH WATER AND THE CUSTOMER FORUM

#### Minute of agreed modifications to Scottish Water's draft business plan for 2015-21

#### INTRODUCTION

1. The formal document setting out the procedures for the setting of charges for water in Scotland – "Strategic Review of Charges 2015-21: Innovation and Choice" issued by the Water Industry Commission for Scotland, had at its heart an invitation to Scottish Water and the Customer Forum for water to agree the business plan the Water Industry Commission would consider in determining charges for 2015-21. This Minute of Agreement represents the agreement reached and as sought in the formal procedures for the Strategic Review of Charges 2015-21.
2. This minute of agreement should be read in the context of Scottish Water's draft business plan for the 2015-21 period. Scottish Water's draft business plan is agreed by the Customer Forum unless, and to the extent, modified by this minute of agreement. For completeness, by 28 February 2014, Scottish Water will update its draft business plan for all the matters set out in this minute of agreement to create "the agreed business plan".
3. Where the term 'Customer Forum' is used throughout this document and referring to matters beyond the current process for the price review and current powers to agree, this reference is not intended to imply that a decision has been taken on the future of the Customer Forum and any future role it may have. This is simply a short-hand for consistency and identifies areas where customer input to discussions and arrangements will be appropriate and important, whatever the particular form of that customer body.

#### DELIVERING FOR CUSTOMERS

##### Overall Performance assessment (OPA)

4. Scottish Water and the Customer Forum aspire for Scottish Water's performance to be 'best in class', and this is reflected in the agreed approach towards OPA where a three tier approach is agreed, based around the following thresholds:

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Best in class performance threshold	400	400	400	400	400	400
Leading companies performance threshold	380	381	382	383	384	385

- Scottish Water aspires to be best-in-class, achieving an equivalent<sup>1</sup> OPA score at, or above, 400. It is recognised by the Customer Forum that this is unlikely to happen consistently based on the experience from England and Wales.
  - Scottish Water plans to be leading, achieving an OPA score at, or above, the leading companies' threshold in every year. It is acknowledged by the Customer Forum that, occasionally, this may not be achieved because of significant events.
  - In recognition of this occasional risk to delivering a leading level of customer service, Scottish Water commits to achieving an average OPA score across the 2015-21 period that exceeds the leading companies' performance threshold (i.e.: an average score across 2015-21 that exceeds 382.5).
5. The following detailed points with regard to the OPA have been agreed in addition to those identified for the drinking water quality measure and the waste water treatment compliance measure in the draft business plan:
- Exclusions: the current exclusions that apply to OPA are to continue during 2015-21. Scottish Water to identify and report the exclusions to the OPA calculation to an annual performance review meeting with the Customer Forum.
  - Response to formal complaints: the period for a substantive response to formal complaints to be reduced from 10 days to 5 days.
  - Independent verification of the OPA: Scottish Water to continue to undertake an annual independent audit and verification of its OPA score

#### **Customer Experience Measure (CEM)**

6. A separate Customer Experience Measure (CEM) will be introduced for each of household and business customers. The non-household CEM is to include Licensed Providers, businesses and developers. Scottish Water will work with the Customer Forum on the development of the measures for agreement and implementation by March 2015.
7. The following detailed points with regard to the introduction of a Household Customer Experience Measure (CEM) have been agreed:
- Perception survey: the perception survey is to constitute 30% of the qualitative element of the household CEM.
  - The qualitative survey elements of CEM to be conducted independently of Scottish Water.
  - Timetable: Scottish Water to operate the household CEM on a shadow basis from April 2014 with a view to establishing a baseline level of performance during 2014/15 and a CEM improvement plan by March 2015.
  - Affected non-contact customers: A commitment from Scottish Water to work with the Customer Forum in developing for implementation by March 2015 a separate component (weighting to be agreed) element of household CEM covering the customer experience of Scottish Water's response to planned and unplanned

<sup>1</sup> The equivalent score reflects that, given the revised scoring being introduced for drinking water quality and Scottish Water improvement plans for SOSI, Scottish Water's equivalent score will be between 3 and 4 points below that recorded in England & Wales. Only one company has achieved an equivalent score above 400 points.

Scottish Water service events from those customers who are likely to have been affected but have chosen not to contact Scottish Water.

- SPSO complaints upheld: These are given a weighting of 1000 times 'unwanted' contacts within the CEM. Scottish Water will also report on escalated and SPSO complaint levels in the annual performance review meeting (see note 17).
  - 'Calls Abandoned' and 'All Lines Busy': to be included within the quantitative element of CEM.
  - Independent verification of the CEM: Scottish Water to seek independent audit and verification of its CEM score.
8. It is agreed that the disaggregated elements of the household CEM can and will be benchmarked with the Service Incentive Mechanism (SIM) in England and Wales as it is constituted currently. It is noted that SIM is currently under review and any changes to SIM which would affect comparability with CEM will be discussed with the Customer Forum to assess any effect on the understanding of CEM this might have.
9. Scottish Water and the Customer Forum will keep the relative weightings of the components of the CEM under review.
10. Scottish Water and the Customer Forum recognise that further steps could be taken to achieve a better understanding of business customers' perceptions of the service outcomes they experience and agree that they will, together, seek to conclude discussions with all relevant parties aimed at developing a non-household CEM by March 2015 to capture:
- Licensed Providers' views as a customer of Scottish Water.
  - Scottish Water component of business users' experience.
  - Scottish Water service to the Developer community.
11. Scottish Water are taking steps to develop improved working relations with business customers where that is relevant to matters specifically under the direct control of Scottish Water and which may facilitate business growth. Scottish Water will engage with the Customer Forum in reviewing progress on this strand of work.

#### **High Esteem Test (UKCSI)**

12. Scottish Water and the Customer Forum agree that benchmarking Scottish Water's customer satisfaction against other utilities and companies in other sectors would be of value. Scottish Water and the Customer Forum have agreed that Scottish Water will bring forward its proposals for building a robust benchmark tracking survey to the Customer Forum for agreement and implementation by March 2015.



**Additional Service Activity Measures**

13. Scottish Water will work with the Customer Forum to agree separate service activity measures in the following areas for implementation from April 2015.

- external flooding due to hydraulic overloading.
- the annual number of properties externally flooded.
- visible leakage.
- carbon footprint reduction.
- extreme weather events excluded from OPA.
- SPSO escalated complaints and upheld complaints.

**Customer engagement:**

14. Scottish Water and the Customer Forum are committed to working together throughout the 2015-21 period on deepening customer engagement. Each year, as appropriate, a wider programme of research into customers with particular service requirements will be conducted. This work may encompass, for example, vulnerable customers, customers within particular geographic areas, customers with particular service improvement needs, research to inform future customer driven priorities and long term issues such as lead pipe replacement, rural sewerage provision, and private water supplies.

**Customer education:**

15. Scottish Water and the Customer Forum agree that there is more that can be done to get close to customers and to help customers co-produce outcomes for themselves and the water and waste water system as a whole, through more comprehensive customer education, care and support arrangements.

16. Building on work done to improve customer education on blockages to sewers caused by customer behaviours, Scottish Water will engage with the Customer Forum during 2014/15 with a view to developing potential approaches to education, care and support programmes, and the subsequent trialling and evaluation of such programmes.

**Annual review meeting**

17. The Customer Forum and Scottish Water agree that there will be an annual meeting between Scottish Water and the Customer Forum specifically for the purpose of looking at levels of service and performance as represented by: OPA; the CEM; the High Esteem Test (UKCSI); Wholesale KPIs - and the component parts of each; and other agreed service activity measures under development. Following any such meeting the Customer Forum undertakes to write to Scottish Water identifying any issues it considers relevant to the question of service level and wider performance monitoring, and Scottish Water agrees to consider the issues raised.

## **CUSTOMER PRICES**

18. The financial modifications and mechanisms set out in this minute of agreement are intended to achieve the following prices for customers.

### **Household customers**

19. There will be an overall household price cap of CPI-1.75% across the 2015-21 period – this is the overall price control that is consistent with achieving annual nominal price increases of 1.6% in 2015-21 assuming that actual CPI adheres to the assumptions given in note 22 below. This mechanism protects both customers and Scottish Water from actual inflation differing from that assumed in this note of modifications. The overall household price cap will be operated in accordance with the following three principles:

- a. A fixed nominal price increase of 1.6% pa in each of 2015/16, 2016/17, and 2017/18 for household customers only, albeit that any over/under recovery of revenue in these three years may be adjusted for in 2018-21 under the price cap arrangements. This follows a limiting of the household price increase in 2014/15 to 1.6% in light of the pricing intention for 2015-18.
- b. An indicative nominal price increase of 1.6% pa in each of 2018/19, 2019/20 and 2020/21 for household customers only, that will be subject to assessment at the time based on out-turn and forecast CPI.
- c. If the application of the price cap methodology would require household prices in 2018-21 to exceed the indicative price increase of 1.6% pa then, prior to the application of such an increase, Scottish Water, the Customer Forum, and the Commission will consider whether any, or all, of the increase above 1.6% can be off-set by overall favourable external factors, re-phasing of IR18 allowances to after March 2021, or by returning any early sustainable out-performance to customers.

20. Affordability: Scottish Water agree to commence work with the Scottish Government and other stakeholders, including the Customer Forum, by April 2015 to investigate if more can be done to support vulnerable customers within the principles of charges laid down by Scottish Ministers.

### **Wholesale customers**

21. There will be a target annual wholesale price change in 2015-21 of CPI-0.3%, but this would be subject to annual adjustment to reflect actual growth and CPI so that Scottish Water's revenue complies with the annual wholesale revenue cap as adjusted for out-turn CPI.

## OTHER FINANCIAL CHANGES

### Inflation assumptions

22. The inflation assumption forecasts are modified as follows:

- CPI for prices will be reduced to 1.9% pa in line with the Bank of England's inflation forecast of November 2013.<sup>2</sup>
- The annual differential between CPI and RPI will be reduced to 0.75%.
- In light of the falling forecasts for RPI, the RPI cost assumptions for 2013/14 and 2014/15 shall be reduced to 2.8% and 2.65% respectively.

This is set out, for clarity, in the table below.

	2013/14	2014/15	Each year from 2015/16 to 2020/21
Modified CPI for prices	-	-	1.9%
Draft business plan CPI for prices	-	-	2.0%
Modified RPI for costs	2.8%	2.65%	CPI+0.75% (i.e.: 2.65%)
Draft business plan RPI for costs	3.0%	2.9%	CPI+0.9% (i.e.: 2.9%)

### Household growth

23. The Commission set out in note 22 that household growth may exceed that set out in our draft business plan. In response to this, the assumption on household growth has been increased from an average of 0.67% pa in the draft business plan to an average of 0.74% pa. This revised average growth assumption is based on an assumed rising annual growth from 0.6% in 2015/16 to 0.9% in 2020/21. The assumed financial consequences arising from this additional growth (in out-turn revenues and costs) are:

	£m
Additional customer revenue	11
Additional infrastructure charge income	7
Additional investment in strategic infrastructure	(4)
Additional reasonable cost contributions	(11)
Additional investment in strategic capacity	(13)
Net cash cost in 2015-21	(10)

24. To the extent that growth exceeds the assumptions set out in our draft business plan, as amended above, the further net additional costs (investment in excess of additional revenue) would require further re-phasing of IR18 investment allowances to after March 2021, beyond those set out in note 27 below.

<sup>2</sup>[www.bankofengland.co.uk/publications/pages/inflationreport/2013](http://www.bankofengland.co.uk/publications/pages/inflationreport/2013)

### Investment levels and priorities

#### Updates to draft business plan forecasts

25. Cash provision is being made for the £61million SR10 investment risk provision that was highlighted in the table commentary accompanying the draft business plan but omitted from the accompanying financial model projections. This cash provision is essential in the context of the Commission's guidance to lower significantly the closing cash balance at March 2021.

26. Recognition, but no overall net cash adjustment, is being made for two compensating understatements in the draft business plan that were identified by the Commission through their business plan review process, which are:

- a cost increase of £21million to correct for an understatement in relation to reasonable cost contributions (RCC).
- infrastructure charge income is increased to reflect an under-statement by £3-4m a year. This will provide additional income that off-sets the additional RCC, albeit that part of this may need to be invested in additional strategic infrastructure capacity.

#### IR18 allowances

27. To create a positive cash balance of £20million at March 2021, £40million (2012/13 prices) of IR18 allowances need to be re-phased to after March 2021. The impact on the phasing of IR18 is set out below.

All figures £m (2012/13 prices)	2018-21	2021-24	Total
Modified IR18 allowances	259	280	539
Draft business plan IR18 allowances	299	240	539
Re-phasing of IR 18 allowances	(40)	40	-

#### Additional investment priorities

28. Any additional priorities for investment including lead pipe replacement pilots, private water supplies and sewerage provision to rural communities, acceleration of Water Framework Directive actions, and reduction in the economic level of leakage will be considered under the rolling investment review in December 2017 taking account of the available financing in relation to section 19 of this agreement. To the extent that financial provision is required for further additional investment priorities the value of the IR18 re-phasing to after March 2021 set out in note 27 above would need to increase further.

#### Improving resilience of water supplies

29. The Customer Forum has sought a robust methodology for assessing the risks, costs and benefits associated with large projects to improve resilience within the system. The procedure set out by Scottish Water in January 2014 provides the basis for such robust assessments and sets out how Scottish Water will consult and seek the support of the Customer Forum on these issues over time. This procedure will be incorporated into appendix 6 to “the agreed business plan”.
30. Scottish Water and the Customer Forum agree that part of the assessment process to be undertaken by Scottish Water into the issues of resilience will include developing a risk assessment to facilitate discussion with customers and allow them to come to judgements about the scale of risk to assets and how it is assessed and the priority for addressing these risks.

#### **Price Promise and Guaranteed Standards**

31. Scottish Water and the Customer Forum have agreed a simplification and enhancement of Scottish Water’s Price Promise and Guaranteed Standards of Service.
32. Scottish Water has committed to merging the two schemes, promoting them to customers using Plain English both in its publications and on the website; and taking a more proactive approach to offering rebate and compensation payments. Scottish Water has agreed that higher levels of payment should be made available and that they will be implemented from April 2015 as follows;
- all the financial payments are updated in light of inflation since they were last updated.
  - on unplanned interruptions to supply to move to give a rebate of 25% to 100% of annual water charge for between 2 and 5 incidents in future, rather than 3 and 6.
  - where a customer suffers from internal sewage flooding, the rebate will be increased to a minimum of Band D level of household waste water charges.

#### **Cash balances**

33. The forecast closing cash balance, including the financial reserve, at 31 March 2021 is reduced to £20million.

#### **Financial performance**

34. Scottish Water and the Customer Forum agree that the description in ‘Innovation and Choice’ that outperformance could potentially be used to “reduce charges, provide additional customer service improvements, improve the condition or performance of the assets in place, or build up its financial reserve” are the appropriate areas for engagement between Scottish Water and the Customer Forum.

35. The Customer Forum accept that "outperformance would be shared at the discretion of Scottish Water at this point, provided its financial strength did not exceed the upper limit of the tramlines", and both parties accept that that "if Scottish Water's financial strength reaches the upper limit and is forecast to stay there for the remainder of the price control period, the company would use the proceeds over that limit to the benefit of customers, subject to the agreement of the Water Industry Commission for Scotland (the Commission) and the Scottish Government".
36. Both parties recognise that Scottish Water will seek to trigger discussions with the Customer Forum, Commission and other stakeholders when the circumstances indicate this would be either beneficial or necessary, with the Commission having the power to determine when discussions under the tramlines should take place if this is not already happening voluntarily. Scottish Water and the Customer Forum recognise that the Scottish Government as owners of the company would have to be party to any agreement on the use of outperformance.

**Summary of the forecast out-turn cash impact of the financial changes and limiting of price increases**

37. For completeness, tabulated below are each of the financial adjustments and their impact on the forecast closing cash balance at March 2021.

Modification	Cash impact of modification £m	Closing cash balance at 31 March 2021 £m
Cash (including financial reserve) balance in draft business plan		117
Additional net investment requirements arising from omissions from draft business plan financial model	(61)	56
Impact of reduction in household price increase in 2014/15 from 3% in draft business plan to 1.6%.	(97)	(41)
Reduction in 2015-21 prices to 1.6%.	(72)	(113)
Reduction in forecast RPI for costs:		
• arising from reduction in 2013/14 from 3% to 2.8%.	18	
• in the annual differential between RPI and CPI from 0.9% to 0.75 in 2014-21	46	
• arising from a reduction in forecast CPI by 0.1% to 1.9%	<u>31</u>	
	<u>95</u>	(18)
Impact of increase in assumed average household growth from 0.67% pa to 0.74% pa	(10)	(28)
Rephasing of IR18 allowances to after March 2021 (£40m 2012/13 prices)	48	20

38. An updated financial appendix containing all of these changes will be provided in 'the agreed business plan'.

Signed

A handwritten signature in blue ink, appearing to read 'Peter Peacock', written over a horizontal dotted line.

Peter Peacock  
On behalf of the Customer Forum

30 January 2014

A handwritten signature in black ink, appearing to read 'Douglas Millican', written over a horizontal dotted line.

Douglas Millican  
On behalf of Scottish Water

30 January 2014


 Appendix  
6

## Financial statements and key financial ratios

This appendix contains the forecast financial statements and key financial ratios of Scottish Water for the period 2015-21. These have been calculated using our financial model. These statements are presented in forecast outturn prices and are based on assumptions on future inflation, financing costs and levels of borrowing.

### Financial statements

#### Regulatory Profit & Loss account

Description	Units	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Turnover	£m	1,067	1,078	1,100	1,123	1,161	1,187	1,213	1,240
Operating expenditure	£m	-359	-372	-383	-395	-404	-413	-421	-432
PPP costs (excluding lease repayment)	£m	-139	-143	-147	-150	-153	-157	-161	-165
Depreciation charges	£m	-250	-252	-255	-258	-260	-262	-265	-268
Infrastructure capital maintenance charge	£m	-102	-109	-118	-122	-125	-129	-132	-131
Amortisation of deferred income	£m	1	1	1	1	1	1	1	1
<b>Operating profit</b>	£m	<b>217</b>	<b>203</b>	<b>198</b>	<b>200</b>	<b>220</b>	<b>228</b>	<b>235</b>	<b>246</b>
Profit or loss on disposal of fixed assets	£m	9	9	5	5	0	0	0	0
Net interest receivable less payable	£m	-159	-164	-166	-169	-173	-176	-179	-183
<b>Profit before taxation</b>	£m	<b>67</b>	<b>48</b>	<b>36</b>	<b>36</b>	<b>47</b>	<b>51</b>	<b>56</b>	<b>63</b>
Taxation – current	£m	0	0	0	0	0	0	0	0
Taxation – deferred	£m	-19	-10	-8	-7	-10	-11	-12	-13
<b>Profit retained</b>	£m	<b>48</b>	<b>38</b>	<b>29</b>	<b>28</b>	<b>37</b>	<b>41</b>	<b>44</b>	<b>50</b>



## Regulatory balance sheet

Description	Units	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Assets and liabilities</b>									
Tangible assets	£m	5,044	5,202	5,400	5,607	5,823	6,011	6,208	6,418
PPP assets	£m	390	383	364	345	326	306	287	268
Third party contributions	£m	-16	-15	-14	-13	-12	-11	-10	-8
Working capital	£m	-297	-300	-300	-303	-303	-305	-306	-310
Cash and cash equivalents	£m	251	240	193	142	92	73	49	19
<b>Net operating assets</b>	£m	<b>5,372</b>	<b>5,510</b>	<b>5,643</b>	<b>5,778</b>	<b>5,925</b>	<b>6,075</b>	<b>6,228</b>	<b>6,387</b>
Borrowings (excl. govt. loans)	£m	-2	-1	-1	-1	-1	-1	-0	0
Investment – other	£m	35	35	35	35	35	35	35	35
Total non-operating assets and liabilities	£m	33	34	34	34	34	34	34	35
<b>Provisions for liabilities &amp; charges</b>									
Deferred tax provision	£m	-457	-467	-475	-482	-492	-503	-515	-528
Post employment asset/(liabilities)	£m	-191	-191	-191	-191	-191	-191	-191	-191
Other provisions	£m	-10	-9	-4	-3	-3	-3	-3	-3
Total provisions	£m	-658	-666	-669	-675	-685	-696	-708	-721
<b>Net assets employed</b>	£m	<b>4,747</b>	<b>4,878</b>	<b>5,008</b>	<b>5,137</b>	<b>5,273</b>	<b>5,413</b>	<b>5,555</b>	<b>5,701</b>
<b>Capital and reserves</b>									
Government loans	£m	3,353	3,463	3,583	3,703	3,823	3,943	4,064	4,184
PFI debt/lease	£m	399	382	363	344	323	302	279	256
Retained earnings	£m	1,053	1,090	1,119	1,147	1,184	1,225	1,269	1,319
Pension surplus/(deficit)	£m	-191	-191	-191	-191	-191	-191	-191	-191
Other reserves	£m	133	133	133	133	133	133	133	133
<b>Total capital &amp; reserves</b>	£m	<b>4,747</b>	<b>4,878</b>	<b>5,008</b>	<b>5,137</b>	<b>5,274</b>	<b>5,413</b>	<b>5,555</b>	<b>5,701</b>

## Regulatory cash flow

Description	Units	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Regulatory income and expenditure</b>									
Turnover	£m	1,067	1,078	1,100	1,123	1,161	1,187	1,213	1,240
Operating expenditure	£m	-359	-372	-383	-395	-404	-413	-421	-432
PPP costs (excluding lease repayment)	£m	-139	-143	-147	-150	-153	-157	-161	-165
Movement in working capital	£m	9.6	3.3	0.1	2.3	0.7	1.2	1.5	3.4
Non-cash adjustment for retirement benefit obligations	£m	-15	-3	-5	-1	0	0	0	0
Taxation paid (ie current taxation)	£m	0	0	0	0	0	0	0	0
<b>Net cash flow from operating activities</b>	£m	<b>563</b>	<b>563</b>	<b>565</b>	<b>579</b>	<b>605</b>	<b>618</b>	<b>632</b>	<b>647</b>
Interest received	£m	1	1	1	0	0	0	0	0
Interest paid	£m	-159	-165	-167	-170	-173	-176	-179	-183
PPP finance lease repayments	£m	-17	-18	-19	-20	-21	-22	-23	-24
Net cash flow from returns on investment & servicing of finance	£m	-174	-181	-185	-189	-193	-198	-202	-206
Net cash flow before capital investment and maintenance charges	£m	388	382	380	390	411	421	431	441
<b>Capital expenditure and financial investment</b>									
Capital enhancement expenditure	£m	-216	-235	-266	-270	-276	-246	-251	-255
Capital maintenance expenditure	£m	-276	-286	-298	-308	-318	-329	-340	-352
Income from infrastructure charges and grants & contributions	£m	12	8	11	11	12	14	15	16
Disposal of fixed assets	£m	12	10	6	6	1	1	1	1
<b>Net cash outflow from investing activities</b>	£m	<b>-468</b>	<b>-503</b>	<b>-547</b>	<b>-562</b>	<b>-582</b>	<b>-560</b>	<b>-575</b>	<b>-590</b>
<b>Net cash flow before financing</b>	£m	<b>-79</b>	<b>-121</b>	<b>-167</b>	<b>-171</b>	<b>-170</b>	<b>-139</b>	<b>-144</b>	<b>-149</b>
<b>Financing</b>									
New government loans	£m	374	225	240	239	243	243	245	255
Government loans repayments	£m	-289	-115	-120	-119	-123	-123	-125	-135
Gilts reserve	£m	-74	-5	-2	-2	-2	-2	-3	-3
Net cash inflow from financing	£m	12	105	118	118	118	118	117	117
<b>Increase (decrease) in cash and cash equivalents</b>	£m	<b>-68</b>	<b>-16</b>	<b>-49</b>	<b>-54</b>	<b>-53</b>	<b>-21</b>	<b>-26</b>	<b>-32</b>
<b>Net cash flow</b>	£m	<b>79</b>	<b>121</b>	<b>167</b>	<b>171</b>	<b>170</b>	<b>139</b>	<b>144</b>	<b>149</b>

## Key financial ratios

The three key financial ratios chosen as critical indices of Scottish Water's financial position (as in our document, 'Strategic Review of Charges 2015-21: Innovation and choice') are adjusted cash interest cover 2, funds from operations to net debt, and gearing. This section sets the current forecasts of the three financial ratios as the middle line of their respective tramlines. The other tramlines have also been set with respect to these forecasts so that action can be taken if Scottish Water's financial position varies over the period compared with the forecast position.

### Adjusted cash interest cover 2

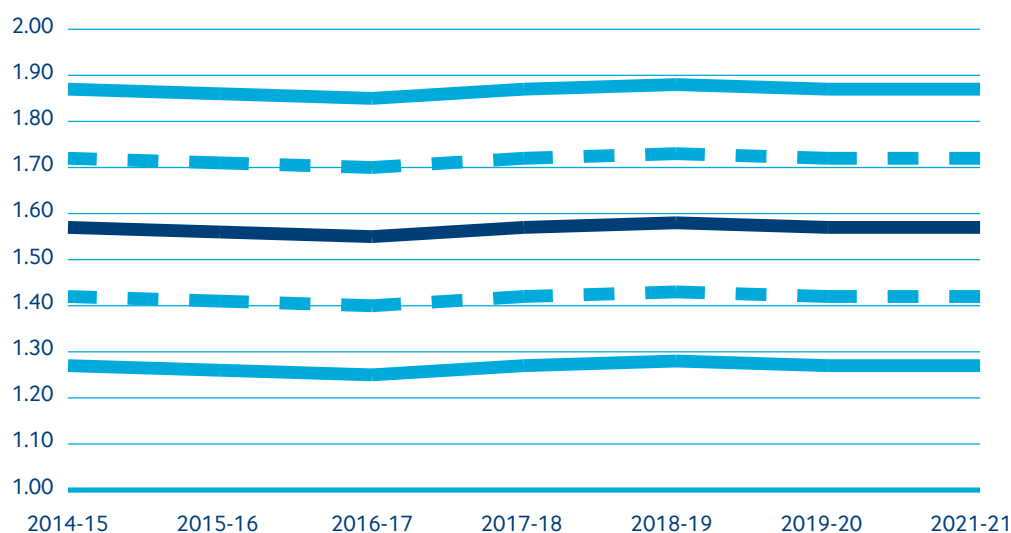
The calculation for the adjusted cash interest cover 2 ratio is as follows:

#### *Adjusted Cash Interest Cover 2*

$$= \frac{\text{Net Cash flow from Operating Activities} - \text{Tax} + \text{Interest Received} - \text{Capital Maintenance Charge}}{\text{Interest Paid (Including PPP interest)}}$$

The following forecasts have been calculated using a three-year rolling average of the previous year, the current year and the next year.

Adjusted cash interest cover 2	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Upper limit	1.87	1.86	1.85	1.87	1.88	1.87	1.87
Discussion line	1.72	1.71	1.70	1.72	1.73	1.72	1.72
Middle line	1.57	1.56	1.55	1.57	1.58	1.57	1.57
Warning line	1.42	1.41	1.40	1.42	1.43	1.42	1.42
Lower limit	1.27	1.26	1.25	1.27	1.28	1.27	1.27



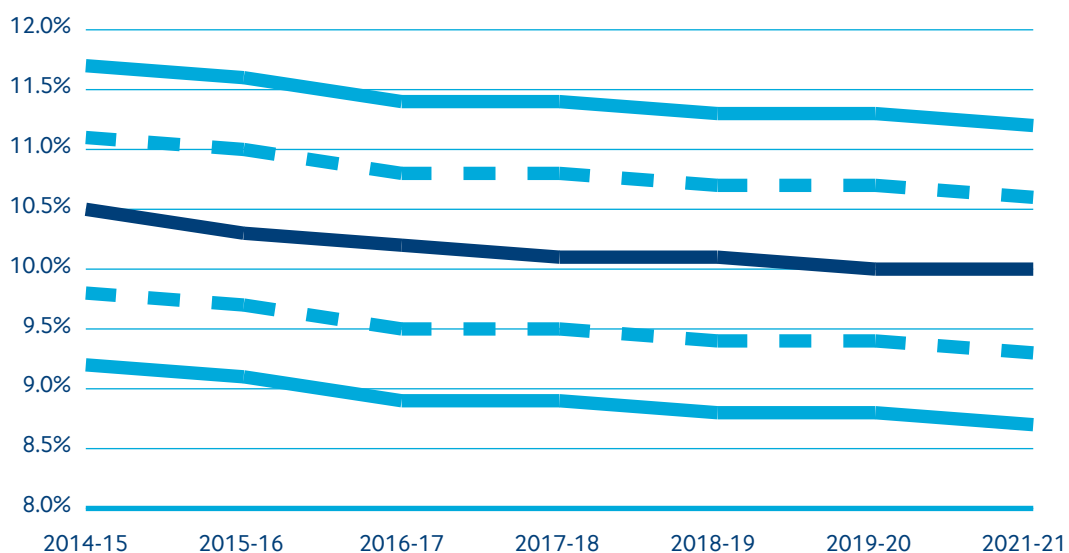
### Funds from operations to net debt

The calculation for the funds from operations to net debt ratio is as follows:

$$\text{FFO: Net Debt} = \frac{\text{Net Cash flow from Operating Activities} - \text{Tax + Interest Received} - \text{Interest Paid}}{\text{Net Debt} + \text{PPP Lease} + \text{Pensions surplus/(deficit)}}$$

The following forecasts have been calculated using a three-year rolling average of the previous year, the current year and the next year.

FFO : net debt	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Upper limit	11.7%	11.6%	11.4%	11.4%	11.3%	11.3%	11.2%
Discussion line	11.1%	11.0%	10.8%	10.8%	10.7%	10.7%	10.6%
Middle line	10.5%	10.3%	10.2%	10.1%	10.1%	10.0%	10.0%
Warning line	9.8%	9.7%	9.5%	9.5%	9.4%	9.4%	9.3%
Lower limit	9.2%	9.1%	8.9%	8.9%	8.8%	8.8%	8.7%



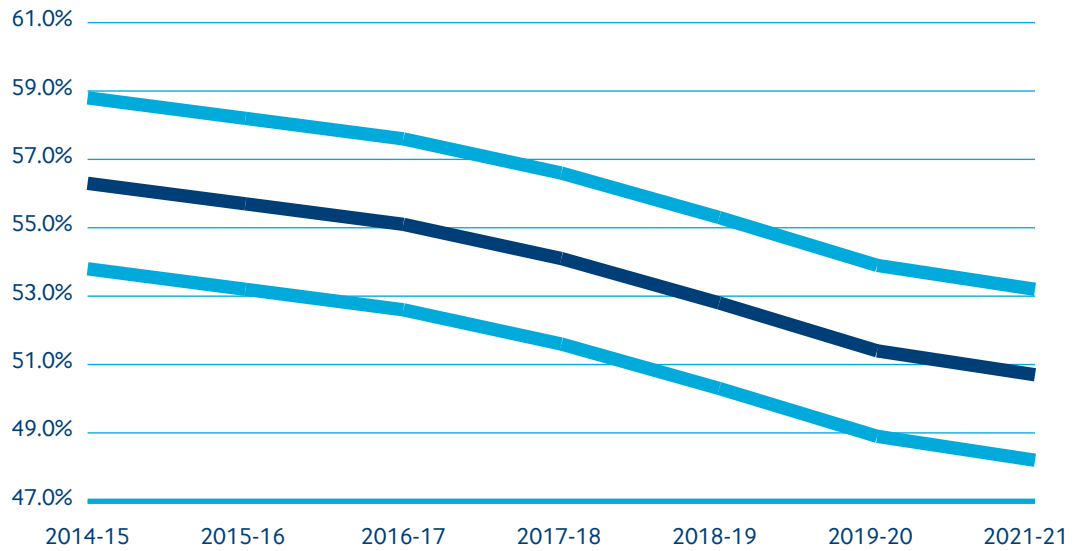
**Gearing**

The calculation for the gearing ratio is as follows:

$$\text{Gearing} = \frac{\text{Net Debt}}{\text{RCV}}$$

The following forecasts have been calculated using a three-year rolling average of the previous year, the current year and the next year.

Gearing	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Upper limit	58.8%	58.2%	57.6%	56.6%	55.3%	53.9%	53.2%
Middle line	56.3%	55.7%	55.1%	54.1%	52.8%	51.4%	50.7%
Lower limit	53.8%	53.2%	52.6%	51.6%	50.3%	48.9%	48.2%

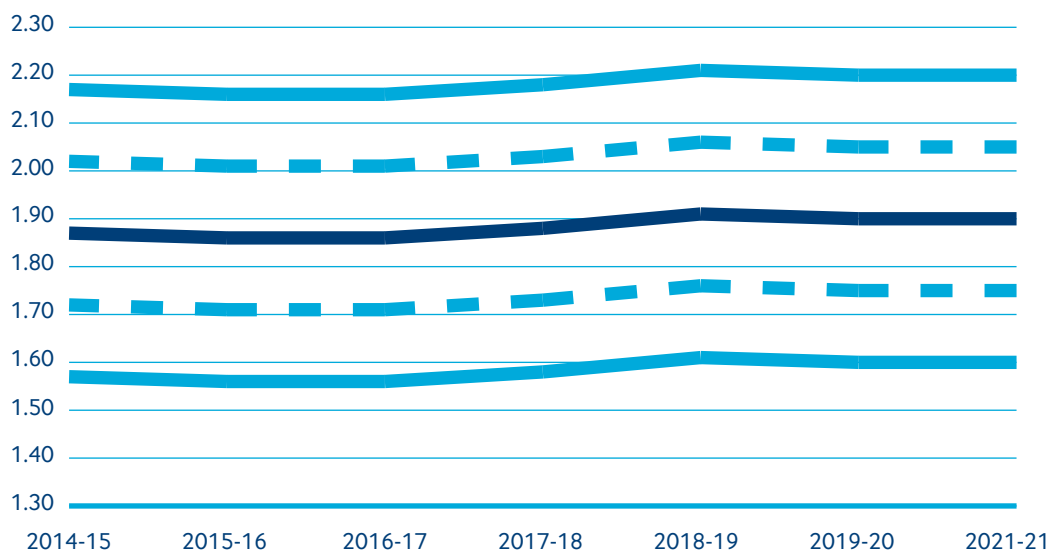


### Index linked debt adjustment

The Commission notes that Scottish Water's financial ratios look artificially low due to not having access to any index linked debt. To adjust for this, it is assumed that 30% of Scottish Water's debt has been refinanced by index linked debt. The impact of this adjustment on the financial strength is shown below.

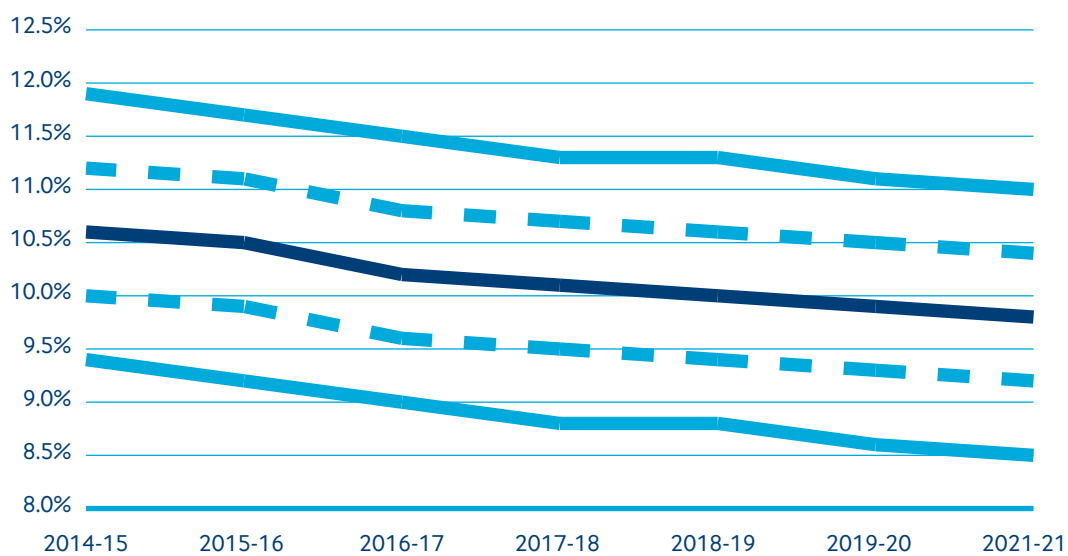
#### Adjusted cash interest cover 2 (with index linked debt adjustment)

Adjusted cash interest cover 2	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Upper limit	2.17	2.16	2.16	2.18	2.21	2.20	2.20
Discussion line	2.02	2.01	2.01	2.03	2.06	2.05	2.05
Middle line	1.87	1.86	1.86	1.88	1.91	1.90	1.90
Warning line	1.72	1.71	1.71	1.73	1.76	1.75	1.75
Lower limit	1.57	1.56	1.56	1.58	1.61	1.60	1.60



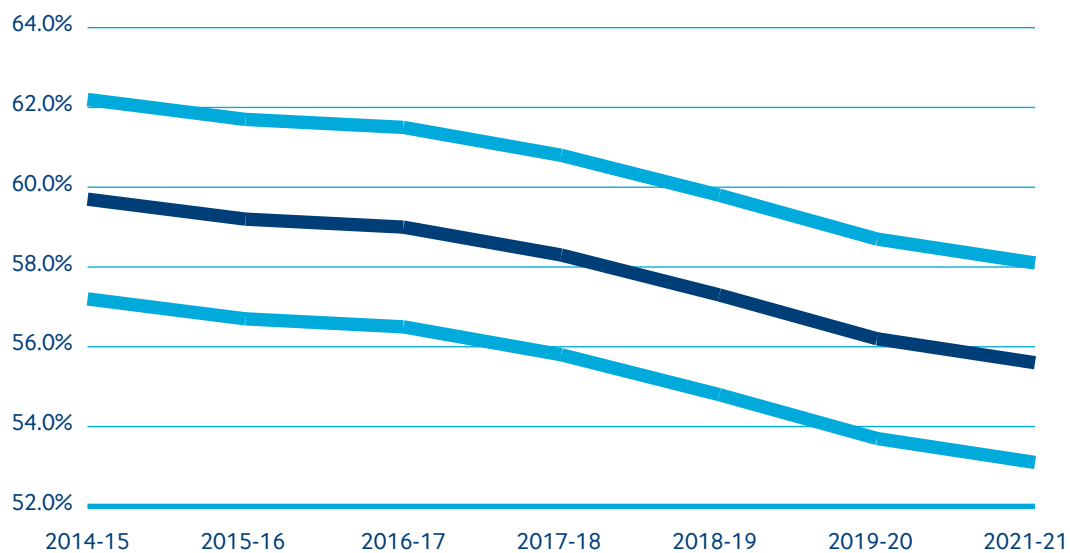
**Funds from operations to net debt (with index linked debt adjustment)**

<b>FFO : net debt</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>	<b>2017-18</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>
Upper limit	11.9%	11.7%	11.5%	11.3%	11.3%	11.1%	11.0%
Discussion line	11.2%	11.1%	10.8%	10.7%	10.6%	10.5%	10.4%
Middle line	10.6%	10.5%	10.2%	10.1%	10.0%	9.9%	9.8%
Warning line	10.0%	9.9%	9.6%	9.5%	9.4%	9.3%	9.2%
Lower limit	9.4%	9.2%	9.0%	8.8%	8.8%	8.6%	8.5%



**Gearing (with index linked adjustment)**

<b>Gearing</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>	<b>2017-18</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>
Upper limit	62.2%	61.7%	61.5%	60.8%	59.8%	58.7%	58.1%
Middle line	59.7%	59.2%	59.0%	58.3%	57.3%	56.2%	55.6%
Lower limit	57.2%	56.7%	56.5%	55.8%	54.8%	53.7%	53.1%







20 March 2014

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