

Initial Decision Paper 3:

The role of the financial tramlines

This is the third in a series of Initial Decision Papers that the Water Industry Commission will publish during the Strategic Review of Charges 2021-27. The Commission will publish initial, revised and final Decision Papers. These Initial Decision Papers set out, for customers and other stakeholders, the Commission's current views on important matters relating to the Strategic Review of Charges 2021-27. They will provide the Commission's views on:

- Strategic issues facing the industry that will impact levels of service beyond the next regulatory control period;
- The prospects for customers' charges during the next regulatory control period;
- Issues that directly and materially impact the charges that customers will pay in the next regulatory control period;
- The potential for Scottish Water to engage even more effectively with its customers; and
- The approach to the Strategic Review of Charges 2021-27.

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review¹, taking account of all the evidence currently available to it in coming to the views set out in these Initial Decision Papers.

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

This third Initial Decision Paper sets out the Commission's current view on the importance of financial stability. It describes the important role that the financial tramlines play in maintaining financial stability for current and future customers and building trust in Scottish Water's performance.

Key messages

The financial tramlines provide a transparent framework for the monitoring of Scottish Water's performance. They ensure both that Scottish Water is financially sustainable and that it is protected from unexpected operational shocks.

We plan to develop the tramlines framework further. Going forward, the tramlines will set out Scottish Water's financial performance in cash terms.

We are also encouraging Scottish Water to be more proactive in engaging with the Scottish Government and the Customer Forum to decide how any funding surplus should be used.

Introduction

The Water Industry Commission has a statutory duty to promote the interests of customers. The Commission is also required to have regard to the interests of future customers. The financial sustainability of Scottish Water both now and in the future is essential if customers are to continue to see improvements in the levels of service provided. Scottish Water operates an asset base with a current replacement cost of more than £60 billion. It is important that these assets are managed effectively and efficiently. Future customers should not be exposed to poorer levels of service or sharp increases in bills as a consequence of regulatory under-funding or financial or asset base mis-management. As such we intend to set prices that are consistent with the effective and efficient management of the water industry in Scotland.

¹ Innovation and Collaboration: future proofing the water industry for customers', published on 10 April 2017 and available on our website.

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At the last Strategic Review, we sought to empower Scottish Water to take full ownership of its decisions, recognising that more financial flexibility could lead to better value for money for customers. We also wanted to ensure that this increased financial flexibility did not expose either current or future customers to any financial shocks.

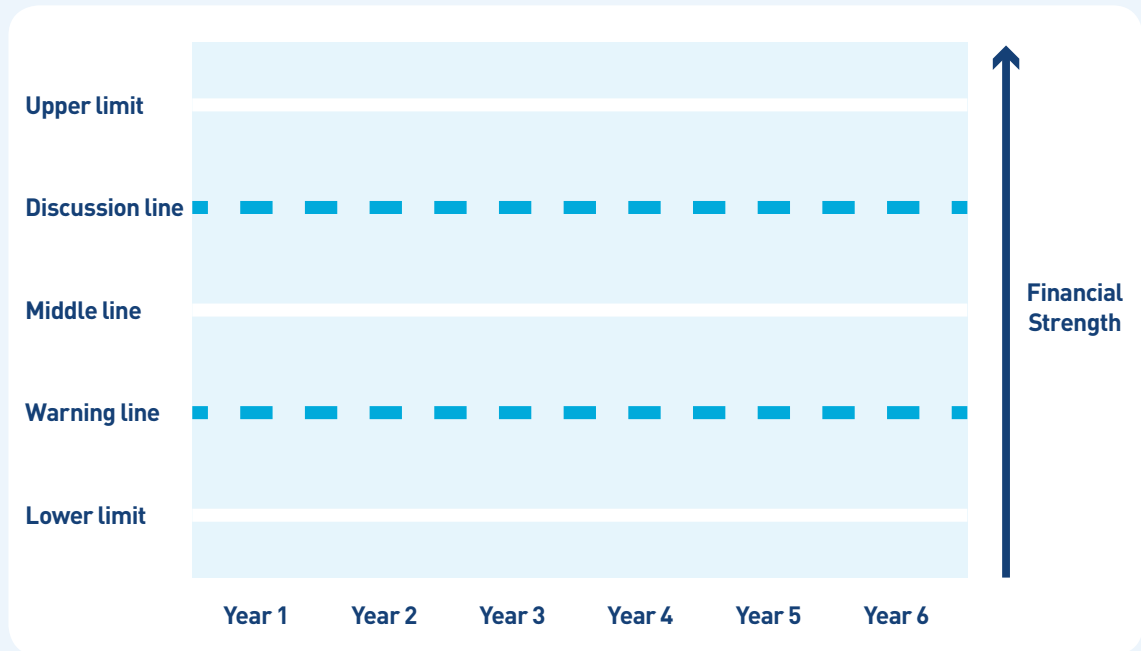
To achieve these goals, we established a range for Scottish Water's allowed level of financial strength consistent with the long term sustainable funding of the industry. We set 'financial tramlines' consistent with this allowed for financial strength.

The tramlines provide a transparent framework for the monitoring of Scottish Water's financial performance. They can also allow us to assess whether Scottish Water is adequately funded to meet known future challenges.

Scottish Water should manage its financial performance within the limits agreed in the tramlines.

The tramlines approach is illustrated in Figure 1. It is described in more detail in Customer Forum Note 7 from the 2015-21 Strategic Review.²

Figure 1: Financial Tramlines



If Scottish Water reports its financial position at a level above the discussion line and it forecasts that its financial position will remain above this level for the remainder of the regulatory control period, we would expect Scottish Water (in pursuit of building the trust of its customers and stakeholders) to begin discussions with the Scottish Government and the Customer Forum about how its funding surplus should be used.

If Scottish Water's financial position were to fall short of expectations, we would expect that Scottish Water would want to explain how and when its financial position will improve in its next Delivery Plan.

² Available on our website at www.watercommission.co.uk/view_CustomerForum.aspx

Taking the approach forward

Scottish Water's performance so far suggests that the tramlines are broadly functioning as intended. The tramlines have provided an increased level of transparency with regard to performance.

The increased financial flexibility available to Scottish Water appears to have encouraged greater innovation, closer joint working with stakeholders, and a move away from a bias towards capital solutions. For example, trials currently underway are expected to identify an operating expenditure solution to the management of wastewater discharges into the Clyde. This approach will result in a significant saving relative to a conventional treatment facility.

There is more that we can do to improve the understanding of the 'tramlines' approach. Presenting the limits of the tramlines as financial ratios probably limits the accessibility of this information. The limits could alternatively be agreed in terms of the cash balance that Scottish Water should maintain throughout the regulatory period.

This cash balance would have to be adjusted for unplanned variances from the agreed business plan but such an approach would bring greater clarity to the monitoring of performance. The Customer Forum could agree these limits. The Commission will set out its decisions on appropriate ranges in due course.

In our methodology³, we explained our view that Scottish Water should seek to build the trust of the customers and communities that it serves. We believe that trust would be enhanced if the Scottish Water Board reviewed its financial position (using the tramlines), and decided in consultation with its owner⁴ and its other stakeholders how any funding surplus during the previous financial year should be managed. There may be an opportunity to share it with customers, to provide for increased resilience or to invest in the maintenance of Scottish Water's assets.

The Board of Scottish Water could likely increase the trust of customers, communities and stakeholders if it produced an annual 'financial performance and funding statement'.

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'Innovation and Collaboration: future proofing the water industry for customers', published on 10 April 2017 and available on our website.

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The Scottish Government will also likely be interested in how any such funding surplus is deployed. It could have implications for Government policy more generally.

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