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Introduction

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

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

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

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

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review, taking account of all the evidence available to it in coming to the views set out in these Decision Papers. The final section of this paper sets out a draft framework for the key performance indicators that the Ethical Based Regulation Review Group will adapt and use to observe and comment on the effectiveness of the revised economic regulatory framework.

The Commission welcomes Scottish Water's proposal to produce a Strategic Plan and, in particular, sees real benefits in Scottish Water's proposal to co-create this Strategic Plan with its stakeholders. The Commission has published refinements and clarifications to its methodology, which reflect these helpful proposals. Stakeholders have expressed a willingness to engage in this process of co-creation.

Scottish Water's adoption of co-creation strengthens the role of the Customer Forum in the Strategic Review of Charges process. The Commission believes that the Customer Forum, acting as a conduit for the views of customers and communities, has an essential role to play in the co-creation of the Strategic Plan.

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Co-creation will significantly enhance the level of customer and community input to the final Strategic Plan. Throughout the co-creation process, the Commission expects the Customer Forum (within the scope of the Objectives and Principles of Charging of the Scottish Ministers and the tri-partite Co-operation Agreement under which it operates) to be a staunch advocate for the views of customers and communities that can be discerned from robust, and collaborative, research.

As outlined in the refinements and clarifications to its methodology, the Commission will revisit its prospects for prices shortly after Scottish Water concludes the co-creation process and finalises its Strategic Plan. The Customer Forum will then be able to discuss with Scottish Water and agree an appropriate profile for prices, within the ranges set out by the Commission, along with the detailed mechanism of any safeguards that it considers to be in the interests of customers and communities. The Commission would be minded to accept such a price profile as its Draft Determination.

It is, of course, possible that the Customer Forum will consider that Scottish Water's Strategic Plan has not taken proper account of the evidence that the Customer Forum provides on the views and aspirations of current and future customers. In such a case, the Commission would expect the Customer Forum and Scottish Water to write to the Commission outlining why no agreement has been possible. The Commission would then revert to a more traditional Draft Determination which would be consistent with its previous Decision Papers; its decisions in March 2019; and its subsequent analysis of the content of Scottish Water's Strategic Plan.

This sixth 2018 Decision Paper sets out the Commission's views on how Scottish Water reports on its performance such that customers, communities and stakeholders can be confident that their expectations are being met.

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The Commission's expectations

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

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

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

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

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Overview

The Scottish Government's Draft Objectives for the industry place a high priority on ensuring the long-term sustainability of the water industry in Scotland. Scottish Water will need to build further the trust and confidence of its customers, regulators and other stakeholders and work closely with them in developing and communicating its strategy. Stakeholders will likely have a particular interest in how Scottish Water plans to report on its performance and how it will demonstrate that it is holding itself to account.

The existing suite of performance measures has served the industry well and helped drive significant improvements. However, stakeholders agree that there is scope to improve the coverage and transparency of the measures and to reflect the transition to the new regulatory framework; including the introduction of the investment planning and prioritisation framework and the requirement to address the asset replacement challenge.

In initial Decision Paper 13, the Commission has previously set out its expectation that Scottish Water should work with its stakeholders to develop the way it reports on its performance. Scottish Water should ensure that the changes proposed in its Strategic Plan reflect the new regulatory framework and provide sufficient reassurance to the Scottish Ministers, customers, communities and stakeholders that their needs are being, and will continue to be, met.

The Commission has worked with Scottish Water and other stakeholders to revise the 'financial tramlines' approach to ensure it provides greater visibility of financial performance and is fully integrated with both the investment planning and prioritisation framework and the approach to long-term asset replacement. This should ensure any outperformance can be quickly identified and directed towards the Scottish Ministers' priorities.

Our methodology document set out an expectation that Scottish Water should "seek trust but expect verification" of its approach to the reporting of performance: it should ensure that its approach is as good as it can be and would withstand any rigorous audit. The Commission would expect that Scottish Water would publish a detailed performance statement (at least) annually and regularly be seeking the views of its customers, regulators and other stakeholders on its progress. This appears likely to be an important element in building the trust of customers, communities and stakeholders, as well as helping build confidence in Scottish Water's ability to deliver Ministerial Objectives and pride in the performance of the industry.

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

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

- If Scottish Water is going to build and maintain the trust and confidence of its customers, communities and other stakeholders, it will have to take clear ownership of its strategy and how it reports on its performance.
- Scottish Water should work with its stakeholders to develop appropriate performance indicators and report on these regularly. It should publish a detailed performance statement at least annually. Such a statement should update stakeholders on Scottish Water's implementation of its strategy.
- The performance statement should also set out Scottish Water's view of its asset management and customer service performance. Customers, communities and other stakeholders are also likely to begin to expect Scottish Water to report its performance in emerging areas such as contributing to natural/social capital, reducing carbon emissions and progress on enabling the circular economy.
- The Commission considered that some consistency in indicators of performance over time was likely to be important.
- By increasing the visibility and transparency of performance, Scottish Water will further build the trust of customers, communities and other stakeholders in its ability to meet Ministerial Objectives.
- Scottish Water should act as though it will be subject to rigorous audit at any time – in other words, it should "seek trust and expect verification".

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

- The Scottish Government's Objectives place a high priority on the long-term stability of the water industry in Scotland. It is likely that a transition to an industry appropriately funded for the long-term will take around two full regulatory control periods.
- Scottish Water has more to do to build the trust of its stakeholders on its approach to asset management, the management of its cash balances and generally on delivering consistent value for money.
- Scottish Water's Strategic Plan could set out how it plans to deliver its Strategic Projections and how it proposes to transition to an appropriate level of funding such that it can replace its assets when the time comes.
- The Commission continues to believe that Scottish Water should report its performance regularly and consistently to all stakeholders. Such regular reporting will maintain and develop further the trust of Scottish Water's stakeholders and their pride in its contribution to Scotland.
- Scottish Water has proposed to co-create its Strategic Plan with its stakeholders. Stakeholders will want to see that Scottish Water listens to their suggestions and responds – Scottish Water will have to avoid any potential temptation to present 'drafts for review', rather than a truly co-created document.
- The Strategic Plan should outline how Scottish Water will report its performance and to what extent current measures remain fit for purpose.

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

- Scottish Water's co-created Strategic Plan should set out clearly where, having benefitted from the input of all its stakeholders, Scottish Water wants to get to, why, and how it plans to get there. In this regard, it is essential that Scottish Water's Strategic Plan maintains and increases the confidence of the Scottish Government, customers and stakeholders that it is operating efficiently and effectively both now and in the future.
- Scottish Water should seek to evidence how it is taking advantage of the new flexibility in the regulatory framework to the benefit of customers, communities and other stakeholders.
- Stakeholders will likely continue to expect Scottish Water to be so effective that it would receive a positive outcome if there were to be an audit. Scottish Water's Strategic Plan is its opportunity to set out how it intends to achieve this. By adopting such an approach, Scottish Water builds trust and meets the challenge in the Commission's methodology: "Seek trust but expect verification".
- Scottish Water may want to consider how it will respond to a view from customers and communities that increases in charges may not be immediately necessary.
- Stakeholders identified that the current performance measures have played an important role in driving improvements. However, they consider that there is scope to rationalise and improve the coverage and transparency of performance indicators to reassure Scottish Government, customers and all stakeholders that Scottish Water is making progress. High-level comparisons with the water industry in other countries will likely continue to be important.
- The investment planning and prioritisation framework will likely change how progress with the investment programme is measured. A broader view will likely be needed; allowing, for example, stakeholders to understand how projects are progressing through each stage of the investment planning and prioritisation framework.

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

- Will Scottish Water's strategy ensure that the water industry in Scotland is focused on the long-term? Will its final revised Strategic Projections and its Strategic Plan be fully consistent? Will the Scottish Government, customers and stakeholders have confidence in the revised performance measures? How long will a transition to an industry appropriately funded for the long-term take?
- Will Scottish Water's co-created Strategic Plan meet the likely expectations of future customers? Are Scottish Water's plans for the next regulatory control period a clear first step in the efficient and effective delivery of its Strategic Projections?
- To what extent do the current performance indicators remain relevant? Do they provide stakeholders with sufficient reassurance that their needs are being met whilst avoiding perverse incentives? What improvements are required?
- How could Scottish Water's reporting on performance demonstrate the transition to a long-term industry and increase the level of pride and trust that customers and communities have in the public sector model for water?
- How will Scottish Water evidence its effective and efficient use of its cash resources?

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

- Scottish Water will have to ensure that its Strategic Projections and the monitoring framework set out in its Strategic Plan fully reflect the Objectives and Principles of Charging of the Scottish Ministers.
- In co-creating its Strategic Plan and the monitoring framework, Scottish Water could reasonably consider:
 - How the organisation will do the right thing for customers, communities, stakeholders and for Scotland more generally - and how will it demonstrate that it is delivering this;
 - How the Strategic Plan will reflect the Strategic Projections and allow customers, communities and other stakeholders to understand how and when the strategy will be delivered;
 - How it can facilitate a single agreed view of performance and progress; and
 - How the performance indicators should be made readily accessible.
- Scottish Water should seek to agree how it reports on its performance with Scottish Government, regulators, customers and other stakeholders as it co-creates its Strategic Plan.
- Scottish Water's co-created Strategic Plan should reflect the information received from the use of behavioural insights and other innovative approaches as well as traditional customer research. In particular, it will be important to seek out views about likely expectations in the future.

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Timetable for 2018 Decision Papers

The Commission published its 2018 Decision Papers on the following dates.

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

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Regulatory framework: Key Performance Indicators

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

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

The Commission has been developing key performance indicators for monitoring, and reporting on, the revised framework for economic regulation. In consultation with Scottish Water and other stakeholders, the Commission has set up an EBR Review Group, which includes independent and international experts who have senior level experience in other sectors or countries. The members of this group are:

- Carlos de Regules who set up and led the National Agency for Safety, Energy and Environment for Mexico (ASEA). He was previously a Director at the Mexican Petroleum Company (Pemex).
- Steve Johnson who was previously Chief Executive Officer at Electricity North West (ENW) and has held several executive roles within the water sector.
- Jean-Yves Ollier who is a member of the French Council of State. He was previously Chief Executive of the French Regulatory Commission of Energy (CRE).

The members of this group will work with stakeholders to refine these performance indicators. Once agreed, these indicators should apply during the current Strategic Review of Charges and in future regulatory control periods. They will test whether the framework for economic regulation¹ is meeting the expectations of stakeholders and that the Scottish industry is making appropriate progress.

The performance indicators will likely be closely linked to key delivery milestones included in Scottish Water’s Strategic Plan. There may also be a range of qualitative assessments that all stakeholders should address regularly. The aim of these regular assessments is to ensure that there is a useful common understanding of whether the regulatory framework is working for customers and communities. Doubtless, such assessments may also identify areas for improvement.

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

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The Commission intends that the EBR Review Group meets regularly with all stakeholders throughout the period of the implementation of the new regulatory framework. They will also work closely with the OECD.

The draft framework for the key performance indicators is set out in the chart on page 12 and reflects six key building blocks outlined in the methodology. The key expectation is that Scottish Water takes full ownership of its strategy.

The Commission trusts that the EBR Review Group will provide a useful and continuing perspective on the performance of the economic regulatory framework. It looks forward to discussing with the Group and other stakeholders the final framework.

Chart 1 – Framework for key performance indicators

