

7

Financial tramlines

Introduction

This is the seventh 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.

7

Financial tramlines

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 Cooperation 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 seventh 2018 Decision Paper sets out the Commission's views on the financial framework that will ensure that the Scottish Ministers' ambitions for the long-term sustainability of the industry are met and that customers receive value for money.

7

Financial tramlines

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. The Commission expected that 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.

7

Financial tramlines

Overview

The Scottish Ministers, customers and other industry stakeholders all recognise the importance of ensuring the long-term financial sustainability of the water industry in Scotland. They also recognise the need to ensure that Scottish Water is spending money effectively and efficiently. This will become increasingly important going forward as the growing understanding of long-term asset replacement needs and other investment priorities – as set out in 2018 Decision paper 4 - will inevitably require careful targeting of financial resources.

The Commission has identified the need to improve a number of aspects of how it ensures that Scottish Water can access an appropriate level of funding (both in the short and longer-term) to meet the needs of the Scottish Ministers, customers, communities and other stakeholders. The aim will be to:

- deliver the Scottish Ministers' requirements for the industry to be financially sustainable over the long-term, while maintaining price stability for customers;
- give customers and stakeholders greater visibility on performance;
- provide appropriate funding for Scottish Water to meet the expectations of the Scottish Ministers, its customers and other stakeholders in the next regulatory control period and beyond;
- allow flexibility to meet future challenges, whilst maintaining the hard budget constraint and incentivising efficiency; and
- ensure that Scottish Water maintains its financial strength and the focus on ensuring long-term asset performance.

This new framework should allow Scottish Water to develop further the trust and confidence of its stakeholders and customers. It allows for greater involvement of stakeholders in how the industry delivers the objectives of the Scottish Ministers.

7

Financial tramlines

Developing the financial ‘tramlines’

A key element of the improvements to the financial framework relates to the ‘financial tramlines’ approach. The Commission introduced the tramlines for the 2015-21 regulatory period and set acceptable operating ranges – initially around key financial parameters – covering all Scottish Water’s operating and capital expenditure. In response to stakeholder feedback, the Commission now considers that the tramlines should be set on a cash basis¹ and cover only operating, financial, responsive repair and refurbishment² and other regular and recurring expenditure. The investment planning and prioritisation framework will review the allocation of all other capital expenditure. This should allow stakeholders to have a clearer understanding of Scottish Water’s performance. Short-term fluctuations in investment expenditure obscured the underlying performance of Scottish Water in the previous approach.

There is still some work to do to ensure that the new approach to the financial tramlines is as effective as possible. This will include finalising agreement and formalising the definitions in Scottish Water’s Strategic Plan:

- the agreement of the definition of the elements of capital expenditure that will fall within - and outside - the tramlines;
- an appropriate operating range;
- how resources could be reallocated between categories of expenditure; and
- how the tramlines sit alongside the other key elements of the new regulatory framework including the investment planning and prioritisation framework, the ring-fenced allowance for long-term asset replacement and the mechanism for the handling of outperformance.

The Commission has also published some refinements and clarifications to its methodology: Innovation and Collaboration. These clarifications and refinements to the methodology complement this Decision Paper.

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

¹ The Commission continues to monitor performance against the previous set of financial ratios as part of its ongoing regulatory monitoring, but the move to simple cash measures for the tramlines provides greater transparency for stakeholders.

² Responsive expenditure that Scottish Water has to incur to maintain levels of service, for example responding to the burst of a water main.

7

Financial tramlines

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

- The Commission has always sought to ensure that Scottish Water is appropriately funded for the long term. It considers that such an approach is essential if customers are to continue to see improvements in the levels of service that they receive.
- The Commission introduced the 'financial tramlines' at its last Strategic Review. Its aim was:
 - to provide transparency to all stakeholders on the financial performance of Scottish Water; and
 - to provide certainty to Scottish Water that, assuming it operated broadly efficiently, it would be funded appropriately.
- However, the 'financial tramlines' did not work as well as intended. Subsequent analysis suggests that there were several reasons for this:
 - The parameters of the tramlines were defined in terms of financial ratios. As such, the underlying performance of Scottish Water was less transparent than was intended.
 - The cyclical nature of investment delivery required large (and not straightforward to explain) adjustments to be made to understand the underlying performance of Scottish Water.
 - The original tramlines process did not reflect external factors that impacted on the settlement: for example, Scottish Water subsequently benefitted from rates rebates that the Commission could not have factored into price setting.
 - The Commission had intended the 'tramlines' to allow Scottish Water to manage its funding transparently and, in so doing, build the confidence of the Scottish Government, customers, communities and other stakeholders. The Commission intended that Scottish Water could, if it out-performed, agree with Scottish Government, customers and other stakeholders how it should deploy this out-performance. In practice, Scottish Water did not take full advantage of the 'tramlines'. They ended up as an ex-post report of financial performance to the Commission.
- The Commission remains committed to the principle of the 'tramlines'. It proposed to define the parameters of financial tramlines in terms of the implied cash balances (equivalent to Scottish Water maintaining its financial strength).
- The Commission suggested that Scottish Water could increase the trust of customers, communities and stakeholders by reviewing its financial position (using the financial tramlines) more frequently and producing an annual 'financial performance and funding statement' with its Delivery Plan to the Scottish Government.

7

Financial tramlines

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

- The Commission is pleased to note the importance attached to the 'financial tramlines' by the Scottish Government. It remains of the view that Scottish Water would build a greater level of trust with its stakeholders if it reported its financial performance and its expected expenditure more regularly.
- The original 'financial tramlines' included all expenditure. It is not clear that capital expenditure should be included. The efficient delivery of a defined capital programme may require study and an iterative option appraisal – a process that does not sit easily with the active and regular monitoring of total available cash resources. However, the Commission considers that it should monitor capital expenditure carefully to ensure that Scottish Water is appropriately funded for the long-term.
- The investment planning and prioritisation framework, if working appropriately, should allow stakeholders to understand the agreed urgency and importance of their needs and aspirations and how and when these may ultimately be delivered.
- The move to the investment planning and prioritisation framework would make including capital expenditure in the cash totals monitored under the 'tramlines' even more complicated. This implies that the Commission should look to amend the financial framework.
- The Commission now considers that the 'tramlines' should cover operating, financial, responsive repair and refurbishment and other regular and recurring expenditure. It should also include the costs of maintaining assets (such as dams) that cannot be allowed to fail and are unlikely, in practice, ever to be fully replaced.
- There should also be a mechanism for the sources of finance (revenue and new borrowing).
- Responsive expenditure would include the resources committed to essential and immediate repair, servicing and refurbishment of assets.
- The range between the bottom and the top of the 'tramlines' could reasonably be reduced as the monitored expenditure is less volatile. The Commission suggests that about £20 million (c. 2.5%) a year above and below the allowed for expenditure could be reasonable.
- When fully operational, the investment planning and prioritisation framework should ensure that the most appropriate solution is identified across all categories of expenditure.

7

Financial tramlines

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

- Stakeholders recognised that the 'financial tramlines' could be useful but only if they were easy to understand and published regularly. They do not currently have as much understanding of Scottish Water's finances as they would like.
- Some stakeholders have expressed concern at Scottish Water's relatively high current and prospective cash balances. All stakeholders are increasingly aware that they need visibility of the resources available to Scottish Water to inform their current and future expectations.
- Stakeholders want the 'tramlines' to provide a 'windscreen' view of performance that provides regular updates on Scottish Water's progress against both the Strategic Review of Charges and the delivery plan that Scottish Water provides to the Scottish Ministers. They support the proposed changes to the overall financial framework.
- Stakeholders recognise that the importance of the 'financial tramlines' will increase in the future. Setting prices that ensure the appropriate funding of Scottish Water for the long-term (rather than the delivery of defined lists of projects) make the 'tramlines' essential.
- In particular, to build the necessary consensus that charges should be increased over time to meet the asset replacement challenge, stakeholders may agree that some of the available funding should be ring-fenced.
- Stakeholders recognise that Scottish Water could build their trust if it pro-actively identified any scope (resulting from revenue, operating or other financial out-performance) for further expenditure in priority areas.
- Subject to Scottish Ministers' decisions, stakeholders will want to be well informed about the potential choices and their cost implications. The new investment planning and prioritisation framework could enable such choices.

7

Financial tramlines

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

- Will Scottish Water set itself an appropriate efficiency target on its recurring expenditure that it will report under the revised 'tramlines'? How will Scottish Water evidence the reasonableness of its suggested efficiency target? Will Scottish Water set an appropriately narrow range for the upper and lower bands of the 'tramlines'?
- How should the financial framework be developed to meet the needs of stakeholders? How will Scottish Water provide sufficient reassurance to its stakeholders?
- How will the 'tramlines' interact with the new investment planning and prioritisation framework? For example, how would the 'tramlines' be adjusted in the event that Scottish Water adopts an operating cost solution to meeting a required outcome?
- How frequently should Scottish Water set out its current and future expected performance relative to the agreed 'financial tramlines'?
- How should stakeholders monitor the resources available for discussion through the investment planning and prioritisation framework? How should any ring-fenced resources and maintenance expenditure be monitored? What would be the process for the release of ring-fenced resources?
- How will Scottish Water use the 'financial tramlines' to build the understanding of, and trust in, its reported financial position amongst its stakeholders?
- Will Scottish Water's analysis of the resources it requires to deal with responsive repair and refurbishment needs be sufficiently robust to earn the confidence of stakeholders?

7

Financial tramlines

The Strategic Review of Charges process is at an early stage. The principal next steps include...

- The Commission has set out its revised financial framework as part of the clarifications and refinements to its methodology. The Commission has published the clarifications and refinements document together with this last batch of 2018 Decision Papers.
- The Commission expects Scottish Water to use the 'financial tramlines' approach for its recurring annual expenditure. Scottish Water should seize the opportunity that the approach offers to build the trust and confidence of the Scottish Government, its customers and other stakeholders.
- The Commission considers that the 'financial tramlines', like the investment planning and prioritisation framework, are fundamental to its approach to setting prices at this Strategic Review of Charges.
- Scottish Water and the Commission will need to work with the Scottish Government and other stakeholders to define how the 'financial tramlines' will work in detail and how they will report on them. Key steps are likely to include:
 - The arrangements for monitoring the level of revenue and new borrowing relative to what was expected in the agreed Final Determination of Charges;
 - The values to be used as a baseline and how stakeholders will be provided with visibility of expenditure allocations;
 - The agreement, in broad terms, of how the 'tramlines' will be changed when Scottish Water adopts operating cost solutions;
 - The interaction with the investment planning and prioritisation framework;
 - The process by which the original allowances in each area may be changed in the light of experience and better information; and
 - The approach to handling any potential out-performance.

7

Financial tramlines

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

7

Financial tramlines

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 regulation³ 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.

³ The Commission’s expectations are set out in its methodology document, ‘*Innovation and Collaboration*’.

7

Financial tramlines

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 13 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

