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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

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.

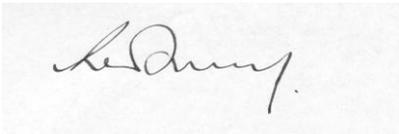
Ministers note that in the 2010-15 regulatory period, the Final Determination provided for £180m to be allocated during the period to finance outputs that would be defined as a consequence of studies. In principle, Ministers are supportive of such a mechanism. However, they request that an analysis is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

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.

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 2015.¹

1.2 SERVICE STANDARDS OBJECTIVES

Build on the improvements made to date and continue to improve services to customers including those measures² agreed with the Customer Forum.

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

² 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 projections³ and the SEPA/Scottish Water *Memorandum of Understanding on the Impact of Proposed Development on the Public System*.⁴

(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.

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

⁴ 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 2003⁵, 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.

⁵ 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.