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Spending for a rainy day

Stakeholders agree SRC21 price rises to future proof Scotland's water

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SPENDING FOR A RAINY DAY

WICS has locked in as its SRC21 draft determination a co-created settlement which will see the start of a series of price rises to future proof Scotland's water.

"Scotland's water is wonderful. Let's keep it that way." This simple but powerful message occupies the whole of the second page in the concise document published last month by the Water Industry Commission for Scotland (WICS), setting out a draft determination for Scottish Water for 2021-27. It pretty well sums up what the Commission – and all the stakeholders who have collaborated to reach conclusions in the latest Strategic Review of Charges (SRC21) – are trying to achieve.

WICS' draft determination formally endorses an agreement reached between Scottish Water and the Customer Forum which will see average price rises of CPI+2% for each of the next six years, about £9 a year more on the average bill. Charges for the period will total £8,032m, funding £4.5bn of investment – 30% up on 2015-21.

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Moreover, the Commission makes it plain in the document that the trend will continue beyond the SRC21 period. It says charges will have to increase by a similar amount in real terms (c 9-13%), over the 2027-33 regulatory period to fund a further real term increase of 28% in the overall size of the capital programme.

Stakeholders have agreed that these are the least reasonable cost charges needed to deliver on Scottish Government Ministerial Objectives and the water sector's new long term vision, which together include: net zero operational and embodied carbon emissions by 2040; maintaining and replacing Scottish Water's ageing asset base in an optimal way (including taking account of carbon and circular economy considerations); and delivering a number of wider social and environmental benefits – from job creation to providing access to land for leisure and wellbeing.

Blocking backsliding

The Commission describes the water sector in Scotland as "at a crossroads". Previous investment has been targeted at improving service (ably achieved, given Scottish Water's rise in the performance ranks compared with English and Welsh water companies since its formation in 2002). Meanwhile, asset lives have been prolonged to lower bills. But now WICS argues service levels are at risk from the ageing asset base and a changing climate, raising the prospect of a backward slide. So the cost of increasing investment must be balanced against the cost of deteriorating levels of service (and so higher future bills), as well as environmental failings including missing the net zero target.

WICS points out by way of stark example that by 2027, 40% of the time available to achieve net zero emissions will have elapsed, so making substantial progress in the SRC21 period is critical. In fact: "Scottish Water should want to be more than 40% of the way towards its 2040 net zero emissions by 2027, given that the last steps towards net zero are likely to be the most difficult."

So should we see the sector vision and Ministerial Objectives as framing the entire review; essentially as setting end point outcomes from which it has been necessary to work back in setting what is needed in the SRC21 period? WICS chief executive Alan Sutherland says: "It's the only way to see it. If we weren't doing that and were just looking at the next five to six years… I suspect we would have ended up in a position where we'd had a price cap for the period of CPI-1% or something each year, and it would have looked like any price review has ever done. The difference is we were very much focused on what is required now to get to the long term, avoiding any really unpleasant shocks for customers or communities in the medium to long term."

Sutherland points out the approach was very much guided by customer sentiment, evidenced by findings from the coordinated research programme (one programme, jointly overseen by all stakeholders) that has underpinned the review. This showed "people do want things like resilient services, they don't want to be going backwards. Increasingly climate change was coming through as an important concern from the customer standpoint."

But Sutherland found a piece of behavioural insight work undertaken as part of the programme especially powerful: "It made it really clear that what customers really don't want is kicking the can down the road, putting off a price increase. 'If you know it's coming, we'd rather either just get on with it or phase it in, but we don't want you to hold bills down for as long as possible and then all of a sudden, a big increase'. That was quite material."

Cash and capital

Working to long term objectives pretty quickly, Sutherland explains, made it untenable to use the traditional regulatory tool, the hard budget constraint. "In the dialogue with Scottish Water, we started to realise the hard budget constraint wasn't even doing what we thought it was doing. We thought the natural instinct for a regulated company was to minimise its costs, and it isn't, it's to minimise its use of cash. That's quite a revelation for us.

"We thought the justification for the hard budget constraint was, well if they're going for the lowest cost solution on a whole life basis, that's all good. But if what they're doing is minimising the use of cash, that doesn't even mean they're picking the lowest cost option. They're picking the option that uses the least cost within a regulatory control period…From our standpoint, it then became a case of 'how do we create a framework which requires focus on the long term and on using the available resources in genuinely the most efficient way possible?'

"That led us to thinking there are things other than financial costs and benefits that accrue. There are benefits in terms of natural and social capital, and costs in terms of carbon and social capital terms in some cases. And how do we make sure we can include those into the equation, because economic regulation has never sought to do that?"

This has led to inclusion in the draft determinations of a £133m ring fenced allowance to cover any additional costs that Scottish Water incurs in selecting an option that has a higher net present value after allowing for externalities such as carbon, natural and social capital than the lowest financial cost option. Sutherland says something of this nature was hinted at in the Commission's February *Prospects for prices* paper, but the number itself is new. He comments: "Here's our way of saying to Scottish Water 'we are very serious about asking you not to necessarily take the lowest cost option, or the lowest cash consuming option. We want you to pick the best option. To the extent you're spending more money, we will dock that from the £133m."

Cost challenge and Covid

To anyone imagining the regulator has effectively written Scottish Water a blank cheque, Sutherland says the draft determination is a million miles from that. It includes a 1% real efficiency challenge year on year on what is called 'Tier 1' expenditure (which covers PFI costs, interest, operating costs and reactive asset maintenance investment), as well as a £150m capital efficiency challenge. "I think the 1% is quite challenging," he shares, calling it "as demanding, as concerted an efficiency improvement as has ever been in the sector – and that is not easy".

He continues: "The second thing – which I think is actually the more challenging bit – is that traditionally regulators have not, in period, looked very hard at the efficiency or otherwise of capital programme delivery. It's been a snapshot at the start of the period and a snapshot at the end of the period and an assessment made as to whether what was expected was delivered reasonably efficiently or not. What this is asking is for Scottish Water to engage with its stakeholders and demonstrate the right sorts of decision for the right sorts of reason and being able to show why it is spending the amount of money it is spending. By that being a public, shareable process, then that engenders a degree of pressure I don't think has ever been put on a regulated utility before."

The efficiency challenge will be all the tougher because no concessions have been made to either the expenditure of efficiency levels set out in WICS' February paper to take account of Covid-19 impacts. The Commission absolutely acknowledges the profound effect the pandemic is having on society and by association on Scottish Water, but rather than lower the bar, it has opted to remove the fixed profile of charges it would otherwise have expected to give the company flexibility to manage the situation.

"Life's just completely different to six months ago," Sutherland observes… "But if you look at the costs on a long term basis, there isn't really any particular reason why you would expect things to be different in the medium to long term. This is unlikely to be a permanent structural change in the economy. It might move around as growth or contraction happens…but once we have a vaccine, or cure or palliative or something…essentially the same challenges are still there, the same future costs are still there."

Moreover, he says there will be savings as well as additional costs to factor in. "We could have made spuriously accurate assumptions as to how much this was going to cost. We've got a fair handle on the pressures they've been under…but projecting what will happen over the next two, three, four years is probably not a very sensible thing to base anything on."

Instead, Scottish Water is to propose charges in its Annual Scheme of Charges, which will be informed among other things by ongoing customer engagement (see below). "It might be that the right thing to do is not increase prices next year, or not increase them by very much," Sutherland mulls.

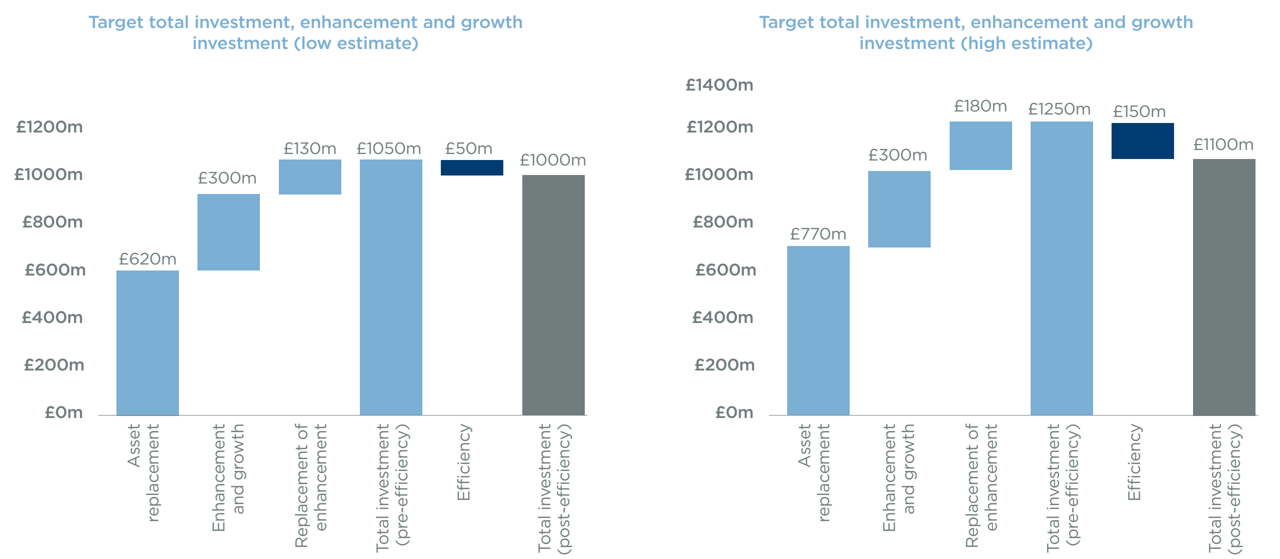
Speaking frankly

The draft determination is the culmination of three years of work, and, as indicated above, has involved extensive regulatory innovation. Alongside removing the hard budget constraint and factoring in non-financial capitals, WICS has followed Ethical Business Regulation (EBR). It has offered transparency (including through the publication of 23 decision papers along the way explaining its evolving approach) and accessibility, including through its concise and accessible draft determination paper. It has pursued a frank dialogue with Scottish Water, and expected Ethical Business Practice (EBP) from the company in return.

Sutherland comments: "It's honestly quite amazing the extent to which we were talking at each other rather than to each other before. And you don't even realise you're doing it. I don't think they realised they were doing it to us, and we certainly didn't realise we were doing it to them."

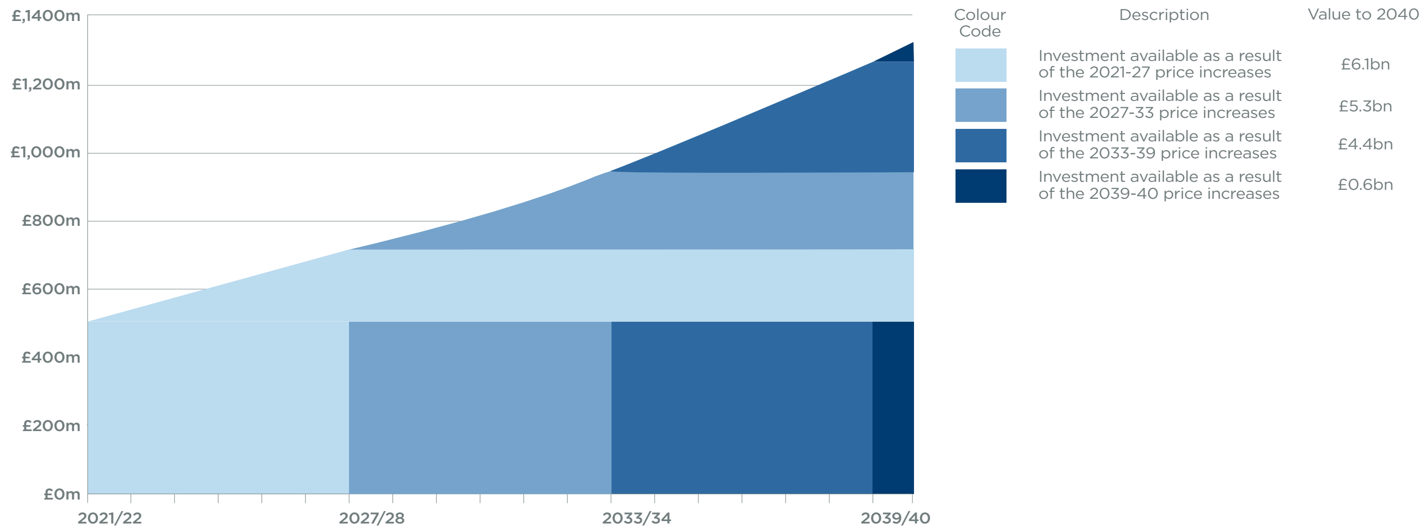
More open conversation has been tough at times. "What they do is they reveal a whole series of issues which are difficult to deal with… Initially there's elements of 'can I really say this and not have them throw their hands up in horror'? And there was a

THE MINIMUM LIKELY LEVEL OF INVESTMENT IN 2040 WILL BE £1.0BN TO £1.1BN



ACHIEVING A LEVEL OF INVESTMENT THAT WILL UNDERPIN NET ZERO EMISSIONS BY 2040 IS DEPENDENT ON SCOTTISH WATER INCREASING ITS REVENUE DURING THE NEXT FOUR REGULATORY PERIODS

Additional investment from revenue increases during each SRC (£m; 2017/18 prices)*



sense initially that EBR was all about being nice to people rather than being clear about what you thought and why you thought it. So there has been a journey in communication."

He says explaining why decisions have been made has in fact been really challenging. "It's a new requirement. When you layer on top of that, that you need to monetise the costs and benefits of carbon and natural and social capital and it becomes even more difficult. A large amount of time and effort has been committed to and is still being committed to getting that process to work as well as it possibly can. That is going to take time, there's no doubt about that. It is going to require Scottish Water to do things in a very different way. But I think when we pull it off – because I think it's a question of when rather than if – the outcomes for customers will be an awful lot better."

Evolution of the Customer Forum

Stakeholders have also been invited in to the process, and research conducted on a shared and coordinated basis. Sutherland says: "It really has been a constructive process of engaging all the different stakeholders. I suspect everyone who reads the document will see something of their input into it – well, hopefully they do."

Customers have played an especially important part. The original role envisaged for the Customer Forum evolved enormously over the review period, moving beyond having a say on price to co-creating Scottish Water's strategic plan and generally playing a broader and deeper role. Sutherland comments: "It's a huge change. There's probably no better example of the extent to which we've had to change the whole regulatory framework than the change in remit of the Customer Forum in this process."

He explains: "We went into this with an expectation that if we could clearly delineate a playing field, we could leave it to customers to talk about tariffs. When you introduce the question of time and your transition over a 20-odd year period, that gets much more difficult to do. It was becoming clear there were challenges that, frankly, we were all learning how to deal with, and it seemed a very sensible thing to do to broaden the remit of the Forum to seek to represent the views of customers in the process at all available opportunities."

That changed the dynamic entirely, he says, from one of constructive but necessarily adversarial negotiation over price – "that's got the potential to be quite toxic" – to one of co-creation, seeking a balance and avoiding negotiating tension. "It would seem to us to be incredibly important that that be avoided. Because ultimately Scottish Water has got to have the trust of its customers, and negotiating per se is not a good way of engendering trust."

He advises: "I think the lesson I take away from this is, if you are going to involve customers in the process, and I think you really, really need to involve customers in the process, then it needs to be a total involvement. It can't be a partial involvement; it can't be something that sits on the sidelines as some kind of 'ra ra' cheering or boo and hiss. It can't be anything like that. It's really got to be a deep involvement and a deep commitment."

Having thrashed the issues out together so far, customers are now set to play an ongoing role. Scottish Water and the Forum have agreed some ideas which seek to support Scottish Water to become more customer centric and community focused. These include for a rolling national engagement programme and a commitment from Scottish Water to adopt the principle that 'every decision should be the one it would take if the customer were in the room'.

Sutherland: "The challenge for Scottish Water is, how are you going to maintain the trust and confidence of your customers and explain to them why you're doing what you're doing, and how you're doing it and all that sort of thing? That's incredibly

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important. Scottish Water has agreed to this principle with the Customer Forum which I thought was an absolutely great one – that Scottish Water take all decisions as though a customer was sitting in the room…That's [EBP] to an A* standard as opposed to an A or A- standard, because it's holding yourself to an accountability level which is really really high."

Transformation Plan

Alongside involving customers and communities in decisions, the Commission is looking to Scottish Water to make ambition reality across the board. Its draft determination paper said: "The Commission has made the first move. It has reformed how it regulates Scottish Water precisely to give Scottish Water the opportunity to think long term, transform its organisation and meet the challenge of net zero emissions by 2040. Scottish Water must now take clear ownership of its performance and meet the challenges that it faces."

The company is expected to define a Transformation Plan to 2040, with milestones, resourcing and regular updates, to deliver the long-term vision set out in its Strategic Plan. "The onus is now on Scottish Water to evidence that everything it does is for the benefit of customers (both now and in the long term) and fully to justify its investment needs."

The Commission notes that Scottish Water will have to make difficult choices in prioritising its investment by the end of the next regulatory control period – according to what it can deliver, what will build stakeholder trust, and what will meet the expectations of customers and communities on current and future prices and service levels. This will also necessitate taking account of circular economy principles, the benefits of natural and social capital, and the costs of carbon over the lifetime of its assets.

WICS has said it also expects Scottish Water to:

- Take full ownership of enduring relationships with the customers and communities it serves.
- Promote an open discussion of its purpose, aspirations and values.
- Set out clearly – and in a way that is accessible to all – its current performance and plans for improvement.
- Engage in regular and frank discussion of performance, recognising that performance expectations will always change and become more demanding.
- Adopt a collaborative, timely and pro-active approach to meeting the needs and aspirations of its regulators, aiming to address their concerns even before they have had to ask.
- Embrace these challenges as an opportunity – and be seen to do so in a positive and constructive way.

Sutherland says both he and Scottish Water chief executive Douglas Millican have agreed: "To achieve what's being asked for here in terms of this settlement is probably a bigger change and challenge for Scottish Water than even the merger of the three authorities and the big catch up with the companies in England. It's fundamentally changing the organisation and future proofing it… Unless we take these steps to really embed things like carbon and natural and social capital, company purpose and all that sort of stuff into the way we go about doing things, then it's going to be virtually impossible to achieve the end outcomes."

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Future regulation

WICS is planning to publish its final determination on 10 December. This will take in responses to the draft, as well as Ministers' Final Principles of Charging and Objectives for the sector, which are due to be published this month.

Perhaps to reinforce that SRC21 is the start of a transformation journey for Scottish Water rather than an end in itself, the Commission included in its draft determination an indicative timetable for SRC27, as well, as mentioned earlier, a forward look at price prospects. The charts shows that average annual investment levels will need to reach £1bn-£1.1bn by 2040 if Scottish Water is to meet its net zero target, and how revenue needs to rise over time.

Sutherland comments: "If you want to do this in a way that is as affordable as possible for customers, then it becomes really important to strike a balance between the current generation of customers and future generations of customers. One of the things that is frequently overlooked is if you're having a set percentage each year, because the baseline of charges goes up, future 2% increases are bigger than current 2% increases…so it's a question of current customers paying their share of the transition."

Are there others ways of doing this? "Of course – you could delay until everything is going horribly wrong then have a big bill." He says that's what's happened in Flint in the US, where bills have increased 25-30% to address lead; and in Cape Town in response to water shortages. "But if you want to do it in a gradual way and explain honestly to customers what's required, then you have to be open about what is it you're trying to achieve and why."

He accepts the criticism that it is impossible to predict accurately how much will ultimately need to be spent. "We don't even know that things done by physical assets today will be being done by physical assets in the future." However "you've got to assume the assets – particularly underground – will need replacing with something and that something, even with innovation and best practice …is not going to be hugely cheaper than before. If it is, that's great, we get to our end point much quicker and have stable prices earlier. There's obviously a risk it goes the other way and health and safety pressures and other challenges increase costs."

The contrasts between SRC21 and PR19 are stark, including in terms of planning horizon, price outcomes for customers, process and spirit (contrast the collaboration in Scotland with the acrimony at the Competition and Markets Authority in particular). Sutherland observes: "Until there's an open discussion, you're not going to surface the issues that need to be addressed. That is complicated dare I say by shareholders and private ownership and all that stuff. But if you've got the right sort of owner who's interested in the long term, that surely is possible too." TWR