This is the thirteenth in a series of Initial Decision Papers that the Water Industry Commission for Scotland will publish during the Strategic Review of Charges 2021-27. The Commission will issue 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 Regulation1 and intends to conduct a transparent and collaborative price review, 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 Initial Decision Paper discusses the changes required to the monitoring of Scottish Water that follow from the proposals set out in the first twelve Initial Decision Papers. This will ensure that the company continues to drive service improvements for customers.

Philosophy of the Strategic Review of Charges 2021-26

- This Strategic Review seeks to build on the successes of the Scottish water industry over more than 15 years and, in particular, the clarity of the governance framework within which Scottish Water operates.
- The Commission expects Scottish Water:
  - to take full ownership of its performance;
  - to work increasingly closely with its customers and the communities that it serves; and
  - to seek trust but expect verification.
- Building trust will likely require enhanced transparency, and a focus on innovation. Increased focus on innovation and improved transparency should:
  - assist in improving the responsiveness of the industry; and
  - should support the Quality regulators in fulfilling their statutory functions.

Key messages

The statutory framework and guiding principles underpinning the performance of the water industry in Scotland are clear. The Scottish Ministers set objectives for Scottish Water and the Commission establishes the lowest reasonable cost for delivering these objectives. DWQR and SEPA monitor compliance with the relevant drinking water and environmental standards. CAS is the statutory consumer body, while SPSO oversees complaints.
Scottish Water is required to demonstrate to these stakeholders that it is successfully delivering the Scottish Ministers objectives and meeting the standards set and improvements required. Our methodology document sets out an expectation that Scottish Water should “seek trust but expect verification.” The industry has made excellent progress but there is no room for complacency. For example, capital maintenance and asset replacement are likely to become increasingly important, but there is currently little information on how expenditure on capital maintenance is committed and how effective it is. As we explained in Initial Decision Paper 7, there is work to do to understand the magnitude of the expenditure that could be required.

As a key element of this approach, we would like to see Scottish Water set out clearly, each year, how it thinks it is performing in a detailed performance statement (providing a more detailed assessment in relation to its delivery of the Ministerial objectives set than in its Annual Report).

To build and maintain trust, such a performance statement would likely include traditional performance indicators such as the Overall Performance Assessment (OPA) and Overall Measure of Delivery (OMD). It will need to be a robust self-assessment and commentary on performance that will withstand the robust scrutiny of customers and other stakeholders.

Scottish Water’s performance statement would be a good opportunity to highlight any issues (both challenges and opportunities) that it sees on the horizon. For example, stakeholders may reasonably expect Scottish Water to reflect on progress in emerging areas such as developing natural/social capital, contributing to carbon reduction and progress on enabling the circular economy.

In Initial Decision Paper 8, we explained how we see merit in separating the process of establishing and formalising the need for investment from the ‘Technical Expression’, which is the defined list of agreed and costed projects that are required to meet the objectives set by the Scottish Ministers. Such a step could be achieved by building on the success of the Output Monitoring Group (OMG) and learning appropriate lessons. The OMG has been very successful in ensuring that Scottish Water delivers its objectives in a timely way and, in our view, there is scope for a similar approach to encourage Scottish Water to seek greater stakeholder collaboration and ensure the industry continues to be as successful and sustainable as possible.
Introduction
Each of our initial decision papers discusses the further development of the regulatory regime to allow for greater ‘Innovation and Collaboration’ during the Strategic Review of Charges 2021-27 and beyond. These include ways to increase the level of engagement with customers, the piloting of new and innovative approaches, and the steps required to allow Scottish Water to own and develop further its strategy.

Our approach to this Strategic Review of Charges increases the onus on Scottish Water to deliver its statutory responsibilities to the satisfaction of its customers and other stakeholders.

We now want to see Scottish Water report robustly on its own performance. In so doing, Scottish Water knows that its report will be considered carefully by stakeholders, including the Commission, customers and other stakeholders. Appropriately candid and detailed reporting will be essential if Scottish Water is going to build and maintain the trust of its stakeholders. It is, however, for Scottish Water to decide how best to report on its performance and meet the expectations of these stakeholders.

This may mean that some of the current performance indicators will change or be further developed but, overall, we expect that the performance of Scottish Water will be more transparent and even more rigorously reported. The Commission plans to comment on Scottish Water’s assessment of its performance. Doubtless, the Quality regulators will continue to do likewise. Parliament may also wish to scrutinise such reports.

Current monitoring tools
The Commission has established a range of monitoring tools over time to measure and track the performance improvements of Scottish Water. It has used the available information about the performance of the water industry in England and Wales in order to make appropriate comparisons and ensure that customers in Scotland are receiving value for money.

These performance measures include high level indicators, such as the Overall Performance Assessment (OPA) and the Overall Measure of Delivery (OMD), along with the specific targets for leakage and pollution incidents.

Originally developed by Ofwat to compare the companies in England and Wales, the OPA is a composite measure of both asset performance and customer service. It has been used as an incentive measure to drive performance at Scottish Water since 2003. At the last Strategic Review of Charges, Scottish Water and the Customer Forum agreed to maintain the OPA measures and set a modestly higher target range for performance. They also agreed to develop a Customer Experience Measure (CEM) and the so-called High Esteem Test. In a positive sign of the sort of pro-activity on performance reporting that we would like to see, Scottish Water saw the introduction of these additional measures as important steps towards their vision of being ‘trusted to care for the water on which Scotland depends’. These two new measures appear to be working well: crucially, they appear to be increasing Scottish Water’s focus on customer service.

The Output Monitoring Group (OMG) is responsible for monitoring the delivery of Ministers’ objectives. The Scottish Government chairs OMG and SEPA, DWQR, the Commission, the Consumer Futures Unit, the Scottish Public Sector Ombudsman (SPSO) and Scottish Water attend. The future challenges faced by the industry suggest that the OMG could usefully be extended to include the review and monitoring of Scottish Water’s appraisals and assessments of its needs. We discuss this in more detail below.

Future proofing the monitoring regime
Scottish Water will doubtless want to review the current performance indicators and assess that they are appropriately aligned with the delivery of Ministers’ objectives and its strategy for meeting the needs of stakeholders, customers and communities. It would likely be important for Scottish Water to explain and agree any changes or enhancements with its different stakeholders. Confidence is normally increased when consistent year on year progress (allowing for events beyond management control) can be shown to have been achieved.
It seems likely that being seen to contribute to carbon reduction, the circular economy and natural/social capital will become more important. Scottish Water has indicated to us that it plans to comment on and measure its performance in these areas going forward.

In Initial Decision paper 7, Futureproofing service levels, we discussed the increasing importance of ensuring sustainable asset management. Expenditure in this area already accounts for over half of the capital investment programme and it is likely to be important for Scottish Water to demonstrate to customers and stakeholders that this expenditure is being spent effectively and that they are managing the service in a sustainable way.

In Initial Decision Paper 5: Communicating cost effectiveness, we set out an expectation that Scottish Water should share its investment appraisals with stakeholders. These appraisals are likely to be important in facilitating effective dialogue between Scottish Water, its customers and communities. They are also an opportunity for Scottish Water to explain the wider benefits of its activities.

In Initial Decision Paper 8: Capital Enhancement, and Initial Decision Paper 11: Innovation, we set out our view that separating the agreement and definition of needs from the ‘Technical Expression’ could allow more time and space for innovation and improve the efficiency of delivery. It also allows for more time for discussions with customers and communities.

The development of performance reporting and the prioritising of investment outputs suggests a broader remit for the OMG. The key will be to ensure that Scottish Water continually has sufficient visibility of its capital programme to get best value from its supply chain.

**Building on the success of the OMG**

Currently, the OMG provides an important role in monitoring the delivery of Ministers’ objectives and ensuring a joint stakeholder view of progress. The report of the OMG is published each quarter on the Scottish Government’s website.

In our view, there is scope to build upon this success and to allow for more joint discussion of Scottish Water’s appraisals and assessment of needs and, more generally, on the key future opportunities and challenges facing the water industry.

Multilateral discussions and collaboration seem to us to be vital if the industry is to achieve strategic innovation in areas such as surface water management, integrated catchment management, developing ‘green cities’ and achieving carbon reduction requirements. It now seems worthwhile to add discussion on strategy and the definition of needs. This would allow Scottish Water to take a stronger lead in these discussions and demonstrate its ownership of its strategy and its desire to work collaboratively with its many partners.

A high level outline of how this additional scrutiny and discussion could complement the existing output definition and monitoring process is set out in Figure 1 below. The extended remit of the OMG would allow it to support Scottish Water in establishing how Ministerial Objectives can best be taken forward to the point where there are clearly defined needs which can then developed into agreed and costed solutions for inclusion in the ‘Technical Expression’. This approach would enable stakeholders – including, where appropriate, external partners such as local authorities and other agencies – to work collaboratively to develop strategic, innovative and optimal approaches to meeting the Ministerial objectives. It would also be beneficial for stakeholders to be more aware of project appraisals, asset maintenance and resilience needs.
It seems to us that such an approach would enable greater collaboration between stakeholders at a senior level, and therefore encourage more frequent and productive engagement. It would build on the constructive discussions which already occur at the OMG. This proposed extended remit for the OMG could support Scottish Water in improving its performance.

One of the potential advantages of this approach would be to allow the Strategic Review of Charges to focus on the longer term and more strategic issues facing the water industry in Scotland. The Strategic Review would continue to assess the likely efficient cost for Scottish Water to deliver the Scottish Ministers’ Objectives for the water industry in Scotland. Prices would be set that take into account the longer term challenges that Scottish Water will have to address. This more strategic price setting process would also allow for more flexibility as to how the objectives of the Scottish Ministers can be most effectively and efficiently delivered. The discussions at an OMG with such an extended remit would help to build the necessary consensus for a sustainable Scottish water industry. There may also be scope to consider the benefits of widening the membership of the extended OMG.

There is also scope to consider how such an approach could insulate the industry from any potential fluctuations in the level of Government borrowing that could occur. By seeking to allow a greater degree of fluidity in the process of establishing the Technical Expression, it would seem possible to respond more effectively to a marginal change in the debt finance available during the regulatory period.
Reporting
As explained earlier, Scottish Water will remain responsible for delivering its statutory duties and reporting on these in its annual report. We would now like to see it go further and report in detail on its performance and prospects (in a manner not wholly dissimilar to the detailed reports on costs and performance that we used to produce). In so doing, we expect it to ‘seek trust, but expect verification’. Such reporting of performance is actually the norm – any well regarded company will report publicly and in detail to its stakeholders. Such reports will cover both performance and prospects over the short and longer term.

Under this approach, the Commission would no longer produce an annual performance report but will instead provide a public commentary on Scottish Water’s performance report.