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Introduction

This is the eighth, and final, 2018 Decision Paper for the Strategic Review of Charges 2021-27. The Commission published thirteen Initial Decision Papers during 2017. The 2018 Decision 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. Co-creation will significantly enhance the level of customer and community input to the final Strategic Plan.

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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 eighth 2018 Decision Paper sets out the Commission's current views on the level of charges that will maintain stable prices for customers, allow for effective and efficient delivery of the required levels of investment and facilitate the transition to a water industry that is appropriately funded for the long-term

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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. 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.

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Overview

In Initial Decision Paper 2, the Commission set out its preliminary views on the Prospects for Prices for the 2021-27 regulatory control period. Our analysis suggested that Scottish Water would have to invest more than the historic average to maintain its assets, improve levels of service and meet more demanding water quality and environmental standards. Given this, and the possibility of reduced levels of borrowing being available, the Commission could not rule out the possibility of price rises above inflation. Our analysis indicated scope to mitigate the impact of price increases by starting the transition in the current regulatory period.

The Scottish Government has now published Scottish Ministers' draft Principles of Charging and Investment Objectives for the 2021-27 period. These include the requirement for the Commission to ensure prices remain stable for customers and to take account of the long-term financial sustainability of the industry. As discussed in 2018 Decision paper 7, the Commission will have to ensure that Scottish Water is appropriately funded to deliver the Objectives of the Scottish Ministers and meet the expectations of customers. This will require us to allow for a transition in the level of funding available to Scottish Water in order that it can replace its assets at the appropriate time. This transition allows Scottish Water to demonstrate to its customers, regulators and other stakeholders that it is a highly effective asset manager. It will also allow time for the new investment planning and prioritisation framework to be fully effective.

The Commission remains of the view that, over time, substantially increased investment will be required and that, consequently, charges will likely have to increase above the rate of CPI inflation during the next two regulatory control periods. Scottish Water has proposed working with its customers, regulators and other stakeholders to co-create its Strategic Plan.

The revised financial framework set out in the Commission's refinements and clarifications to its methodology for the Strategic Review of Charges 2021-27: 'Innovation and Collaboration', explains how the Commission plans to comment on Scottish Water's costs. It separates recurring costs from those that can be planned. In practice, this means that all responsive capital expenditure (to deal with an immediate and urgent asset failure or a shortfall in levels of service) is viewed similarly to operating costs, interest costs and the costs of the Public Finance Initiative contracts. The planned capital expenditure looks likely to have to increase significantly over the next several regulatory control periods. This reflects the continuing water quality, environmental and growth expenditure, but also an increased need for expenditure on the planned repair, refurbishment and replacement of assets. Consistent with 2018 Decision Papers 4 and 5, at this stage the Commission considers that the level of planned replacement and enhancement expenditure will likely exceed £650 million in 2012/13 prices and may be as high as £850 million.

The Commission considers that the transition to an appropriate level of funding should take no longer than ten to fifteen years. The upper end of this range reflects the age profile of Scottish Water's electrical, mechanical and instrumentation assets.

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

- When the Commission started its work on the Strategic Review of Charges 2021- 2027, it believed that the Scottish Government would likely reduce the borrowing that it would make available to the water industry.
- Analysis suggested that recent levels of expenditure on growth and on improving water quality, the environment and customer service were likely to be broadly similar. The Commission also concluded that an increase in the rate at which Scottish Water replaces its assets was likely to be required in the future.
- As such, the Commission could not rule out the necessity of a price increase above the rate of inflation. The level and timing of net investment (capital expenditure required less borrowing available) were the key drivers of whether an increase in customers' charges would be required.
- The Commission considered that it could cut customer bills modestly in real terms in the next regulatory period if it allowed for only a small increase in investment.
- However, any cut in customers' charges looked likely to have implications for future regulatory control periods (if the Commission's expectations of long-run levels of required investment prove to be accurate). Any such cut in charges could require future increases in charges at a rate significantly higher than the rate of inflation.
- The Commission identified that it could mitigate any price increase above the rate of inflation in the next regulatory control period by allowing Scottish Water to increase revenue in broadly equal annual percentage steps from 2019-20 to 2026-27.

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

- In the light of the Scottish Ministers' draft Objectives for the industry, the Commission does not see any benefit to cutting customers charges (relative to inflation) in the next regulatory control period when this would result in significant increases (above the rate of inflation) in the longer-term.
- The Scottish Government is currently indicating that the level of borrowing available over the regulatory control period will be broadly similar to the current regulatory period – this helps off-set any increase in charges required in the next several years.
- Prudent future planning for an appropriately funded industry will likely require price increases at or above the rate of inflation. The Commission believes that investment on asset replacement will need to be substantially higher in the future than in the past. Scottish Water's draft Strategic Projections highlight many of the other challenges that the water industry faces.
- However, the Commission would like to understand how Scottish Water plans to put itself in a position to deliver effectively and efficiently the levels of investment that may be necessary. Scottish Water will have to build the trust of the Scottish Ministers, customers and other stakeholders that it has this capacity and capability.
- The Commission's revised regulatory framework allows Scottish Water the opportunity to co-create its Strategic Plan with its stakeholders. As such, it has allowed for a more flexible timetable for discussions before Scottish Water finalises its Strategic Plan. The Commission is also publishing refinements and clarifications to its methodology at the same time as these Decision Papers, which explain the working of the revised regulatory framework.
- Scottish Water has the opportunity to grow the confidence of the Scottish Ministers, its regulators and the customers and communities that it serves.

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

- Most stakeholders agree that the levels of investment required in the future are likely to be higher. However, they want to have a better understanding of how Scottish Water will spend the resources allowed for in the Strategic Review of Charges. The investment planning and prioritisation framework will play a key role in this regard. There is also a clear view that Scottish Water could do more to evidence its future investment needs.
- Stakeholders believe that Scottish Water could improve the rigour and transparency of its investment appraisal. Project appraisals will ensure that future expenditure is as effective and efficient as possible. Appraisals should consider costs and benefits that are not easily reflected in monetary terms. Scottish Water will also need to demonstrate that it is doing all it can to consider, and take advantage of, any innovative solutions.
- Stakeholders have confirmed the importance that they attach to both the maintenance and replacement of assets. In particular, the Drinking Water Quality Regulator and SEPA have both made it clear that timely asset replacement is essential for maintaining current compliance levels.
- Citizens Advice Scotland and the Customer Forum believe that Scottish Water should do more to engage meaningfully (and at an earlier stage) with customers and communities. The Commission's methodology expressed a similar view, particularly with regard to very complex issues such as asset replacement and long-term investment planning.
- In the absence of such communication, customers and communities could reasonably question whether charge increases are necessary. Scottish Water should seek to evidence its need, how it will grow confidence and how it is building the capacity and capability to deploy the additional resources effectively and efficiently.

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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...

- How effectively will Scottish Water's Strategic Projections and Strategic Plan explain and evidence its transition to an industry that is appropriately funded for the long-term? How long might this transition take? How should charges respond to this evidence? How does Scottish Water demonstrate its progress towards putting in place the necessary capacity and capability to deliver a larger capital programme?
- Will Scottish Water's Strategic Plan and asset information improvement plan be sufficiently detailed? Will the proposed process of co-creation of the Strategic Plan be fully effective? Can co-creation and the accountability of Scottish Water be fully reconciled?
- How might stakeholders' understanding of the timing, efficiency and effectiveness of asset replacement develop?
- How does Scottish Water suggest that any potential investment reserve should work in practice? How, and in what circumstances, does Scottish Water propose that ring-fenced resources be released?
- Will Scottish Water be able to agree the parameters of the 'tramlines' and a comprehensive and inclusive investment planning and prioritisation framework with its stakeholders?
- Will the research strategy for the industry be appropriately strategic and sufficiently ambitious?
- How will Scottish Water perform over the remainder of the current regulatory control period?

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

- Capital expenditure looks likely to have to increase significantly over the next several regulatory control periods. This reflects the continuing water quality, environmental and growth expenditure but also an increased need for expenditure on the planned repair, refurbishment and replacement of assets.
- Having reviewed the draft Principles of Charging, the Commission now considers that the increased investment requirement over the long-term will mean that customers' charges over the medium term will likely have to increase above the rate of consumer price inflation (CPI).
- Consistent with 2018 Decision Papers 4 and 5, at this stage the Commission considers that the level of growth, planned replacement and enhancement expenditure will likely exceed £650 million in 2012/13 prices and may be as high as £850 million.
- The Commission considers that the transition to an appropriate level of funding should take no longer than ten to fifteen years. The upper end of this range reflects the age profile of Scottish Water's electrical, mechanical and instrumentation assets.
- Scottish Water should propose how any such transition in charges is best implemented. Scottish Water may also want to bear in mind that stakeholders have expressed concerns about their current high cash balances.
- Scottish Water's co-created Strategic Plan should set out whether resources will be ring-fenced and the criteria for their release (if appropriate).

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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

