

The Strategic Review  
of Charges 2015-21  
**Final determination**



# Introduction

This final determination sets out the Commission's conclusions on the level of customer charges for the six-year period from 1 April 2015. The charges have been set such that they are sufficient to meet the Scottish Ministers' environmental, quality and customer service objectives for the industry. Our determination also complies fully with the ministerial Principles of Charging.<sup>1</sup>

This final determination represents the last stage of the Strategic Review of Charges 2015-21, unless Scottish Water were to ask us to refer the determination to the Competition and Markets Authority (CMA).

We published our draft determination in March 2014 and received eight representations from a wide range of stakeholders. We carefully reviewed these representations, along with new information on Scottish Water's financial performance and on its levels of service to customers, which became available after we published our draft proposals. The responses we received were broadly supportive of our draft determination. The responses are all published in full on our website. We would like to thank all of the organisations for their contributions in responding to the draft determination.

The Strategic Review has involved significant engagement with other stakeholders, including the Customer Forum, Scottish Environment Protection Agency, the Drinking Water Quality Regulator, and Citizens Advice Scotland. All have worked with a common goal of achieving the best outcome for Scottish Water's customers. We would therefore like to thank all of those involved for their efforts in engaging with and contributing to the Strategic Review process.

---

**1**

The ministerial Principles of Charging and Objectives for the period 2015-21 were finalised by the Scottish Government on 1 October 2014 and are available at [www.scotland.gov.uk/Topics/Business-Industry/waterindustryscot/publications/Policystatments](http://www.scotland.gov.uk/Topics/Business-Industry/waterindustryscot/publications/Policystatments)

# Overview of our approach

We started planning for the Strategic Review shortly after the end of the last review in 2009. Through a project called 'Incentives, innovation and involvement' we identified a number of developments we wanted to make to the regulatory framework. Our aim was to ensure that Scottish Water would be equipped for the challenges of the future and would continue to provide high-quality water and sewerage services at the lowest reasonable overall cost.

Our revised approach is more transparent than at previous reviews<sup>2</sup>. The Commission has made clear decisions about the key inputs to the price review (including operational expenditure, capital expenditure and financeability) and the resulting prospects for prices. These decisions were expressed in terms of ranges that the Commission considered reflected an appropriate challenge for Scottish Water to improve its efficiency – in other words to do more and to do it more effectively for the same amount of money or, even better, for less.

Scottish Water was responsible for the development of its business plans with requirements to ensure the prudent management of its assets and to improve its relationships with its customers.

Our revised approach included establishing the Customer Forum. The Forum's role was to identify customer priorities and to secure the best outcome for customers within the ranges for key inputs to the price review that were set by the Commission in the run up to Scottish Water publishing its draft business plan and immediately after this. The Forum engaged in direct discussions with Scottish Water over a period of several months, representing the concerns of customers and leading to a better outcome for customers than might otherwise have been the case.

The Commission applauds the efforts made by the Customer Forum and Scottish Water to identify proposals that reflect customer priorities for improvements in the costs and levels of service. The proposals set out in this document are consistent with the Minute of Agreement<sup>3</sup> reached between Scottish Water and the Customer Forum in January 2014.

---

**2**

We outlined our approach in detail in a methodology document, 'Strategic Review of Charges 2015-21: Innovation and choice' (May 2013).

---

**3**

The Minute of Agreement is reproduced on pages 73-77 (appendix 4) of the draft determination, which can be found at [www.watercommission.co.uk/UserFiles/Documents/Draft\\_determination\\_2015-21.pdf](http://www.watercommission.co.uk/UserFiles/Documents/Draft_determination_2015-21.pdf)

# Changes since the draft determination

The Commission's conclusions take account of progress made in a number of areas since the draft determination was published.

## Leakage

A new leakage incentive scheme has been included in the final determination that will challenge Scottish Water to accelerate reductions in its level of leakage. Under this scheme, Scottish Water will be permitted to recover in the next regulatory period the £10 million of one-off transition costs required to reach the lower end of the assessed range of the 'economic level of leakage'<sup>4</sup>, provided this is achieved by 2019-20. The incentive scheme allows for an additional £5 million of recoverable costs if the target is achieved a year earlier, or a reduction of £5 million if it is a year later.

Lower levels of leakage will bring benefits for the environment and for customers by reducing the volume of water extracted and treated, and by increasing the reliability of supply. As these transition costs will not be recovered until the next regulatory control period there is no impact on the proposals that were set out in the draft determination.

## Ministerial Objectives and the Principles of Charging

The Scottish Ministers have now finalised their Objectives and Principles of Charging for the 2015-21 period. In doing so, changes have been made to the assistance provided to charitable organisations, including an increase in the qualifying income threshold and the introduction of a transition period for organisations that will no longer qualify. The impact on Scottish Water's customers remains consistent with that anticipated in the draft determination.

## Progress on the new performance measures

Three new performance measures are being developed by Scottish Water and the Customer Forum for introduction in the 2015-21 period. These measures are:

- the household customer experience measure;
- the non-household customer experience measure; and
- the high esteem test.

Similar to the Service Incentive Mechanism developed by Ofwat, the household customer experience measure is built from a quantitative and a qualitative component, although the measures within each component have been adapted to meet the unique needs of Scottish Water and its customers.

The new measure is also the first performance measure to include the views of customers who have experienced an issue with their service but did not make direct contact with Scottish Water.

A similar measure is also being developed for non-household customers. These will help customers and other stakeholders to compare the service that is provided by Scottish Water year on year and, potentially, with services provided by other water and sewerage companies.

The high esteem test will be used to compare Scottish Water's reputation among the public with those of other UK utilities, and also with the country's most trusted companies and brands across all sectors.

4

The 'economic level of leakage' is the point at which further activity to reduce leakage would incur higher costs than the value of the water saved. For the purposes of the incentive scheme, the lower end of the range is taken to be 500 Megalitres per day, subject to adjustments for truly exceptional weather.

## Summary of our proposals

Following our assessment of both the responses received to our draft determination and the new information that is now available, the Commission has concluded that the proposals set out in the draft determination represent a good deal for customers and should now be confirmed in this final determination, with one small addition. The main elements of the proposals are summarised below:

### Charge caps

In these times of ongoing economic uncertainty, we believe it is important that customers are able to look forward to water and sewerage charges that, over the next six years, will not increase by more than the rate of Consumer Price Inflation (CPI). We also believe it is important to offer absolute certainty about increases for the next three years.

For household customers, Scottish Water will be permitted to increase its charges over the period 2015-21 by no more than CPI minus 1.8%. For the three-year period from 2015-16 to 2017-18 its charges will increase by 1.6% per year in nominal terms (in other words, irrespective of inflation). For the subsequent three-year period 2018-19 to 2020-21, prices will rise at CPI minus 0.3%, subject to the overall requirement for prices over the six-year period to rise by no more than CPI minus 1.8%.

**Table 1: Household charge caps**

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Household customers	1.6%	1.6%	1.6%	CPI - 0.3%	CPI - 0.3%	CPI - 0.3%

For non-household customers, Scottish Water will be permitted to increase its wholesale charges at no more than CPI minus 0.3% per year over the period 2015-21. We have also taken a related, although separate, decision about the default maximum retail tariffs which retailers can charge non-household customers. Our decision is to freeze default tariffs in nominal terms for the six years of the regulatory control period. This decision would only be reviewed if there were to be a significant increase in inflation beyond the level that is currently targeted by the Bank of England.

Retail competition for the non-residential sector in Scotland has allowed an increasing number of non-residential customers to negotiate better deals with their retail supplier. In their responses to the draft determination, retailers sought assurances that the Commission would continue to monitor the margins available to retailers and make adjustments where necessary and we can confirm that this remains our approach. Almost all non-residential customers should see their bills fall in real terms and the level of service should continue to improve substantially.

**Table 2: Non-household charge caps**

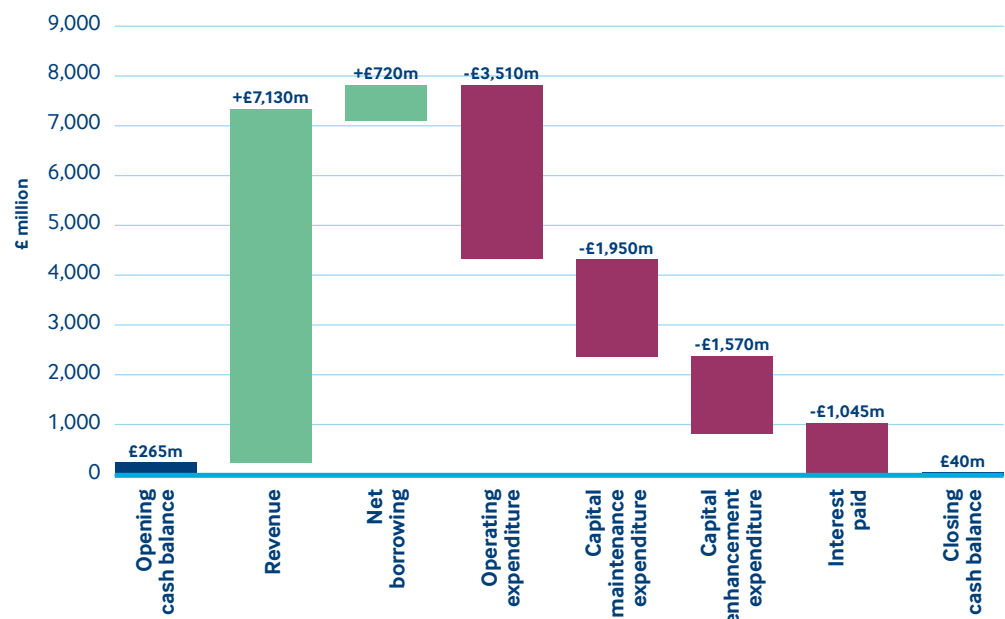
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Non-household customers	CPI - 0.3%	CPI - 0.3%	CPI - 0.3%	CPI - 0.3%	CPI - 0.3%	CPI - 0.3%
Default tariffs	0%	0%	0%	0%	0%	0%

**Operating and investment expenditures**

The Commission has decided that the charge cap for the period 2015-21 should be based on the following assumptions (with all values at 2012-13 prices):

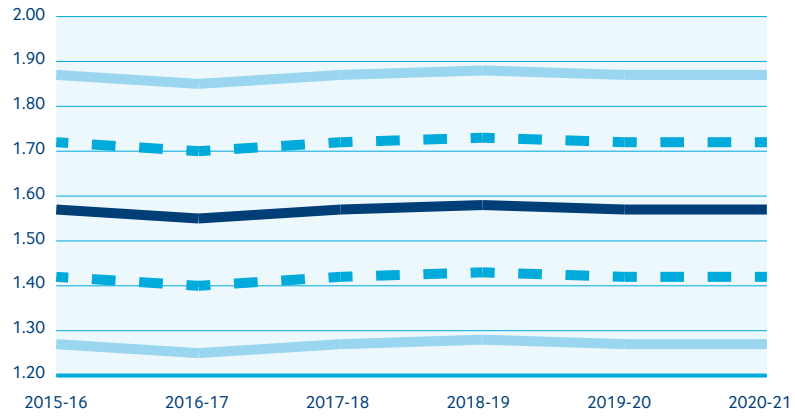
- operating expenditure – £505 million per year;
- capital maintenance expenditure – £280 million per year;
- total enhancement investment (including completions) – £1,356 million for 2015-21;
- financial ratios (ie adjusted cash interest cover, gearing and FFO to net debt) will remain within the financial tramlines set by the Commission.

The figure below illustrates the breakdown of income and expenditure.

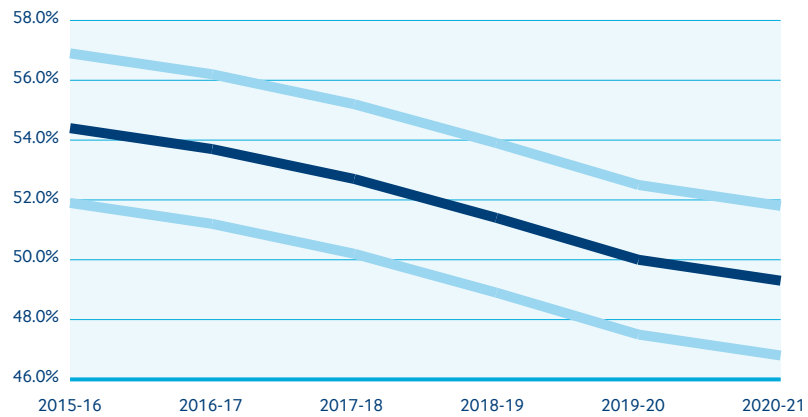


The next three figures illustrate the financial tramlines set around the business plan target for each of the financial ratios.

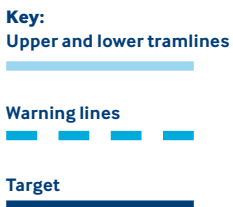
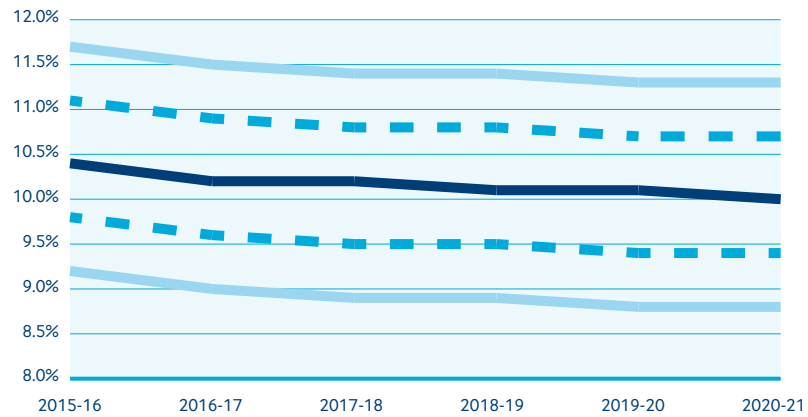
**Adjusted cash interest cover**



**Gearing**



**FFO: net debt**





### Service improvements

Within these resources Scottish Water is expected to improve its service performance over the regulatory period so that it:

- maintains its overall performance assessment (OPA) score within a target range of 380 to 400 points throughout the period<sup>5</sup>;
- ranks among the leading UK water companies on the new Customer Experience Measure to be introduced by March 2015 (see below); and
- is among the leading UK utilities for customer satisfaction.

**Table 3: OPA performance**

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
OPA – upper end of target range	400	400	400	400	400	400
OPA – lower end of target range	380	381	382	383	384	385

In addition, Scottish Water will implement service improvement measures to address priorities identified by customers in relation to external sewer flooding, visible leakage, reduction in carbon emissions, managing responses to extreme weather events, and minimising the number of complaints that are escalated up to or upheld by the Scottish Public Services Ombudsman.

Scottish Water will also set aside at least £40 million for investment to meet quality, environmental and service improvement objectives to be identified at an Interim Review of the investment programme in 2018 ('IR18').

Finally, the company will increase the financial payments made to customers who suffer unplanned interruptions to their water supply or internal sewer flooding.

## Conclusions and next steps

We believe that our final determination is good for customers; good for our environment in Scotland; and good for the Scottish economy. It will allow Scottish Water to build on what it has achieved over the past five years while ensuring that customers receive value for money and the further improvements in service they want.

Price increases that are capped at less than the level of inflation over the period will provide certainty in difficult economic times while ensuring that Scottish Water has the resources to deliver the objectives set by the Scottish Ministers for the industry.

Scottish Water will now consider its response to the Commission's proposals. It has the right to request that the Commission refer this final determination to the CMA within 60 days of this publication. The CMA would then have to decide whether the lowest reasonable overall cost of delivering the Scottish Government's objectives is equal to, higher than, or lower than we have set in this final determination. The CMA would be required to take into account the same issues that we have taken into account.

If Scottish Water decides to accept this final determination, it will prepare a delivery plan for the Scottish Government. This delivery plan must be fully consistent with the levels of performance in costs, environmental and water quality improvement and in terms of levels of service to customers that are set out in this final determination and in the earlier draft determination.

We will look to that delivery plan to set the interim milestones in performance that Scottish Water should be expected to achieve. Our monitoring will be against those milestones.



20 November 2014

**Water Industry Commission for Scotland**

Moray House

Forthside Way

Stirling FK8 1QZ

T: 01786 430200

E: [enquiries@watercommission.co.uk](mailto:enquiries@watercommission.co.uk)

**[www.watercommission.co.uk](http://www.watercommission.co.uk)**