

FINAL DETERMINATION
**STRATEGIC REVIEW
OF CHARGES 2021-27**

**SCOTLAND'S WATER
IS WONDERFUL.
LET'S KEEP IT THAT WAY.**



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FOREWORD BY THE CHIEF EXECUTIVE

The Covid-19 pandemic has continued to dominate all of our lives since we published our draft determination in October, and we have seen a return to tighter restrictions. Fortunately, there is now much greater optimism on both the efficacy and the availability of a vaccine, and government scientists appear to have more confidence that we will see life returning to something approaching normal in the not too distant future.

However, this pandemic has served to highlight the fundamental importance of a reliable and high-quality water and wastewater service. At its most basic level, you can't wash your hands without water, a point well illustrated by the fact that during lockdown in the late spring of 2020, we each used around 30 litres more water in our homes every day. Recent tragic events have also highlighted the risks and complexity of the wastewater assets which we all rely on Scottish Water to manage.


Recent events have therefore brought home quite starkly the fact that we must not take the improvements we have seen in service, in drinking water quality and in the industry's environmental impacts for granted. Climate change is making it harder to deliver services, affecting raw water quality and increasing sewer flooding, and Scottish Water's infrastructure is ageing. At the same time Scottish Water now faces a challenging 2040 net zero emissions target.

The sector therefore stands at something of a crossroads, but decisions about the future direction must draw on the evidence available on customers' priorities. Extensive research

confirms that customers cherish their water, and want high-quality, value for money services. They also want Scottish Water to provide broader public benefits and to help tackle climate change. I very much welcome Scottish Water's commitment that it will, at all times, act as though there is a customer in the room. It is also encouraging that Scottish Water will engage in a national conversation to build and to maintain as good an understanding of the views and priorities of its customers as is possible. This will require a strong focus and a commitment of resources by Scottish Water.

Our statutory role is to promote customers' interests. As such, we must allow Scottish Water the funding it requires to address the challenges it faces and to ensure that both current and future customers enjoy the same high-quality and reliable services as we do today.

Without sufficient investment, there would inevitably be a gradual deterioration of standards that would become harder to reverse, and substantially more costly, if it were allowed to gather pace.



We recognise that the decisions we are making today are against a backdrop of unprecedented challenges for customers and businesses in Scotland. Our approach therefore allows Scottish Water maximum flexibility to consider the phasing of charge increases over the regulatory control period to reflect, through its national conversation, the preferences of the customers and communities it serves. We are also pleased that the Scottish Government is providing greater protection to those least able to afford water charges through the changes announced to the water charges reduction scheme. This will mean that bills for those who are least able to pay will go up by less than the rate of inflation over the next regulatory control period.

We are playing our part in ensuring that bills are no higher than necessary by setting stretching, but achievable, efficiency targets for Scottish Water.

Meeting these targets will require Scottish Water to transform its business, ensuring it delivers best value in all that it does. In tandem, we are transforming how we regulate – to a model based on ‘Ethical Business Regulation’ (EBR) – while keeping the overall cost to customers of our office below the rate of inflation during the next regulatory control period through income earned from working on international projects. This income from our international work to date will allow us to return over £1.5m to Scottish Water and retailers.

The final determination is an important milestone in building on progress since Scottish Water’s creation in 2002, by doing the right thing for Scotland, for future generations and for the environment. We look forward to continuing to work closely with our stakeholders as we continue on the journey.



ALAN D A SUTHERLAND
Chief Executive

10 December 2020

BACKGROUND

This final determination is the culmination of over four years of research, analysis and discussion with stakeholders. Much has changed since we began our work.

- The United Kingdom has left the European Union; but the Scottish Ministers have indicated an intention to continue to mirror closely the water quality and environmental standards that are in place in the European Union.
- The Scottish Government has declared a global climate emergency and has signed into statute a net zero emissions target by 2045 for all sectors in Scotland. Scottish Water has been set the target of achieving net zero emissions by 2040.
- Covid-19 is the most serious public health crisis in a century. The response is having a major impact on our economy, affecting both households and businesses. The pandemic has brought a renewed focus on the resilience of our public services.

In setting our final determination, the Commission is very mindful of the economic disruption that has been wrought by the pandemic and by the potential impact of our exit from the European Union. However, the Commission is also acutely aware of just how reliant we are on our water service and the long-term impacts that under-investment in the industry would have for future generations.

We welcome the Scottish Government's initiative to increase the extent of discounts available to households through the Water Charge Reduction Scheme. We have also been working with the Scottish Government and other stakeholders on measures to assist non-household customers. These measures include the suspension of the requirement for retailers to pre-pay Scottish Water and the opportunity for businesses to defer payment of their charges with no penalty or interest charge. We have recently extended this deferral scheme and suspension of pre-payment until the end of February 2021.¹ We are committed to working with the Scottish Government, Scottish Water and the retailers in determining when and how the unwinding of these initiatives is pursued.

We have also recently agreed our Corporate Plan and budget for the next regulatory control period with the Scottish Government. This plan sets out how we will regulate Scottish Water and hold it to account while meeting our statutory

duties in inspiring a Hydro Nation. We appreciate the stretching efficiency target that is asked of Scottish Water and, as such, our Corporate Plan includes an increase in our own budget by less than the rate of inflation.

As a result of our efficiency and the international income that we have been able to generate during this regulatory control period, we will be able to return over £1.5m to Scottish Water and retailers.

The final Objectives of the Scottish Ministers require Scottish Water to ensure the ongoing resilience of services and improvements in water quality and environmental performance. These Objectives include the ambitious and far-sighted vision for the industry and charge Scottish Water with making progress towards achieving net zero emissions (on both an operational and an embodied² basis) by 2040. Achieving net zero emissions will require Scottish Water to manage effectively its huge asset base, replacing assets at the right time, and taking account of the need to maintain levels of service while also recognising environmental impacts and the need to keep costs low.

¹ *Letter on Measure in Response to Covid-19_1.pdf (watercommission.co.uk)*

² *We are using the term embodied here to represent the carbon dioxide or greenhouse gas emissions associated with the manufacture and use of a product or service. We take this term to be wider than the term 'embedded' as it allows for the consideration in decision taking of the implications of potential asset decommissioning.*

Scottish Water's assets are substantial, with a replacement value of some £70 billion. This equates to some £30,000 for every household in Scotland (compared to the average household bill of less than £400 a year).

The Commission's role is to ensure that charges reflect the lowest reasonable overall cost for Scottish Water to deliver the Scottish Ministers' Objectives in a manner that is consistent with the Scottish Ministers' Statement of the Principles of Charging. Our work with Scottish Water and our independent analysis, as set out in our draft determination, has made it clear that there will have to be a significant uplift in the level of annual investment if Scottish Water is to deliver these Objectives and to realise the long-term Industry Vision.³

This final determination now establishes the maximum amount of charges that Scottish Water can levy during the six-year regulatory control period 2021-27.

It follows publication in October 2020 of our draft determination, in which we sought the views of all individuals and stakeholders with an interest in the water sector in Scotland on our proposals. The final determination takes into account both the responses we received on the draft determination and the finalisation of the Scottish Ministers' policy for the industry over the forthcoming regulatory control period. The Scottish Ministers' policy framework for the industry is set out in their Principles of Charging and Objectives.⁴

MEASURES TO ASSIST CUSTOMERS

Our draft determination explained that Scotland faces a challenge to maintain service levels, given that the pipes, treatment works and other assets that provide our water and sewerage services are ageing. It also set out how we have to respond to a changing climate, and why we have to invest more, beginning now, if we are to mitigate the risk that service levels slide backwards.

Our draft determination noted that this increase in investment means that bills will have to go up, although not by so much that customers and communities would be paying more in real terms than they were in 2002-03. We explained that delaying the investment would risk even higher bills, reduce service reliability and water quality, and result in a failure to meet the net zero target. Furthermore, borrowing more on an ongoing basis, would simply lead to higher bills in future, which would represent poor value for both current and future customers.

In the draft determination we recognised the financial difficulties that many customers and businesses were facing, and have continued to face, as a result of the Covid-19 pandemic. As noted earlier, we are pleased that the Scottish Government has increased the discount that will be available through the water charges reduction scheme to 35%. This means that charges for those receiving the full discount will increase at less than the rate of inflation over the 2021-27 regulatory control period. We have also noted that the measures put in place to assist non-household customers will be extended.

In our draft determination, we sought to maximise Scottish Water's scope for flexibility in preparing its annual Scheme of Charges, and in the phasing in of any price increases. This flexibility has been retained as a key element of the final determination. Scottish Water has stated that it is committed to engaging directly with customers through its national conversation. Indeed, we are pleased to note that Scottish Water has already begun a programme of research into customers' views of price levels next year (2021-22) given the impacts of the Covid-19 pandemic. We expect Scottish Water's proposed Scheme of Charges for 2021/22 to be supported by evidence from this research.

To ensure that charges are kept as low as possible, we have set stretching annual efficiency targets for Scottish Water for the forthcoming regulatory control period. We expect Scottish Water to reduce its tier one costs (that is, its operating, interest, PPP and reactive repair costs) by 1% each year in real terms. Given that the PPP costs increase in line with the contracts, this efficiency challenge is greater than is faced by the private water and sewerage companies south of the border.

³ <https://readymag.com/ScottishWater/SustainableFutureTogether/5/>

⁴ <https://www.gov.scot/publications/principles-of-charging-2021-2027/>
<https://www.gov.scot/publications/scottish-water-directions-2020/>

ENSURING A TRANSPARENT PROCESS

This final determination has been the result of our most open and collaborative Strategic Review process to date. Our thinking began many months before the publication of our methodology document in April 2017. We published further refinements and clarifications to this methodology towards the end of 2018. Through the publication of a series of 23 Decision Papers, we have set out our views on material aspects of the Strategic Review.

Stakeholders were consulted at every stage and this engagement was underpinned by robust analysis and by an extensive programme of customer research overseen by the Research Co-ordination Group (which comprised representatives from the key sector stakeholders including Scottish Government, Customer Forum, Scottish Water, Consumer Advice Scotland (CAS), the Scottish Environment Protection Agency (SEPA) and the Drinking Water Quality Regulator (DWQR)).

This consultative approach has, we believe, resulted in a significantly better outcome for customers and communities. In particular, we were very pleased that the Customer Forum reached an agreement with Scottish Water that will ensure that customer and community views are at the heart of future decision-making.

Given the importance of the proposals for the long-term future of the industry we set out to ensure that we engaged extensively around our draft determination. We sent electronic copies directly to more than 800 individuals and organisations, and promoted the key messages of the draft determination more widely through articles in magazines and newspapers and through short videos on social media. This reflected our view that we all have a stake in ensuring the long-term future of our water and sewerage services.

We would like to take this opportunity to thank all those who provided feedback on the proposals in the draft determination.

We have carefully considered these responses and taken account of the points made in reaching our final determination. An overview of the issues raised is provided on page 13 and all of the responses are available on our website.

Finally, we see the final determination as an important staging point in the journey that the Scottish water sector is on. It is critical that the strong and open dialogue we have had to date continues. We welcome the dialogue that Scottish Water will have with its customers and communities through its national conversation. For our part, we will continue to work closely and collaboratively with all stakeholders throughout this coming regulatory control period.

OUR FINAL DETERMINATION

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OUR FINAL DETERMINATION

The following section sets out the Water Industry Commission for Scotland's final determination of charges under the Water Industry (Scotland) Act 2002. This final determination establishes the maximum amount of charges that Scottish Water may levy on its customers.

The final determination of charges reflects the Water Industry Commission for Scotland's view of the lowest reasonable overall cost that Scottish Water should incur in meeting the Objectives set by the Scottish Ministers in a manner fully consistent with the Scottish Ministers' Final Statement on the Principles of Charging.


“ During the regulatory control period, 2021 to 2027, the maximum amount of Scottish Water's charges is limited to £8,024m.⁵ Supported by an increase in government borrowing to £1,030m, Scottish Water will be able to invest just over £4,500m before 2027. This will represent an increase of £1,095m (around 30%) from the allowed-for investment in the 2015-21 regulatory control period. **”**

We have included a £150m capital efficiency challenge in our assessment of the long-term sustainable level of investment. The maximum amount of charges that Scottish Water can levy on its customers is set at CPI+2% on average for each year of the regulatory control period.

The charges cap includes a demanding 1% real efficiency challenge year-on-year in the allowed-for 'Tier 1' expenditure (which covers PFI costs, interest, operating costs and reactive asset maintenance investment).

For the first time, it also includes a ring-fenced allowance of £132m to cover any additional costs that Scottish Water has incurred in selecting an option that has a higher net present value (NPV) than the lowest financial cost option, after allowing for externalities such as carbon, natural and social capital. Scottish Water will only be able to access this ring-fenced allowance if these additional costs and benefits are clearly evidenced in an appraisal.

⁵ The revenue figures provided in the document are in 2018-19 prices while, for comparison purposes, investment figures are provided in 2017-18 prices.



Scottish Water must propose charges in its Annual Scheme of Charges that are consistent with this average annual cap and the cumulative application of this cap.⁶ The Commission is willing to consider any Charges Scheme that could be consistent with the overall cap on the amount of charges that can be levied on customers during the 2021-27 regulatory control period.

The Commission has a statutory duty to promote the interests of customers and, in so doing, have regard to the interests of future customers. As such, within this final determination, the Commission would expect that its charge caps would allow Scottish Water's annual revenue in the final year of the current regulatory control period 2026-27 to be no less than £1,392m.⁷

This level of revenue is consistent with ensuring that future generations of customers are not disproportionately impacted by the costs of both achieving net zero emissions and of replacing a backlog of worn-out assets (with their associated additional emissions). By ensuring such a transition in revenue, Scottish Water is looking after its future customers and ensuring that levels of service to current customers are not compromised.

We would expect around 70% of the total income from customers over the regulatory control period to come from households, with the remainder coming from non-household customers. This is our expectation based on our analysis of the historic costs incurred in serving household and non-household customers. The Commission will carry out further work with Scottish Water and other stakeholders to review relative cost allocations between household and non-household customers, should Scottish Water consider that new evidence is available and that the current allocation is no longer broadly cost reflective.

In addition, the Scottish Government has made available new borrowing of £1,030m to support the delivery of improved outcomes for customers. This is an increase from the previous period of over £300m.

⁶ *Scottish Water could propose a higher charge cap in any one year. Provided that the Commission understood the rationale, the customer interest and how this would be consistent with this final determination, such a higher increase could be approved. Scottish Water's Scheme of Charges will have to reflect changes in the customer base from the modelling assumptions used for this determination. These assumptions are unchanged from our February 2020 decision paper.*

⁷ *The revenue figures provided in the document are in 2018-19 prices while, for comparison purposes, investment figures are provided in 2017-18 prices.*

BENEFITS FOR CUSTOMERS AND COMMUNITIES

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Our final determination allows Scottish Water to deliver wide-ranging, long-lasting benefits for Scottish customers and communities.

BEST VALUE FOR CUSTOMERS:

- Today's levels of service to customers are overall as good as has ever been recorded by any water and sewerage company in Great Britain. Our final determination allows Scottish Water to ensure that these high service standards are maintained now and into the future.
- The final determination allows Scottish Water the flexibility to reflect the results of its national conversation in its annual Scheme of Charges.
- As part of an overall package of measures, charges for those in receipt of full relief from Council Tax will see average price increases below inflation over the 2021-27 period.
- No household in Scotland will see their bill increase by more than £2 a month above inflation in each year. The average bill will increase by less than 80 pence a month – around £9 a year – above the rate of inflation each year.

A FLOURISHING ENVIRONMENT AND DRINKING WATER TO BE PROUD OF:

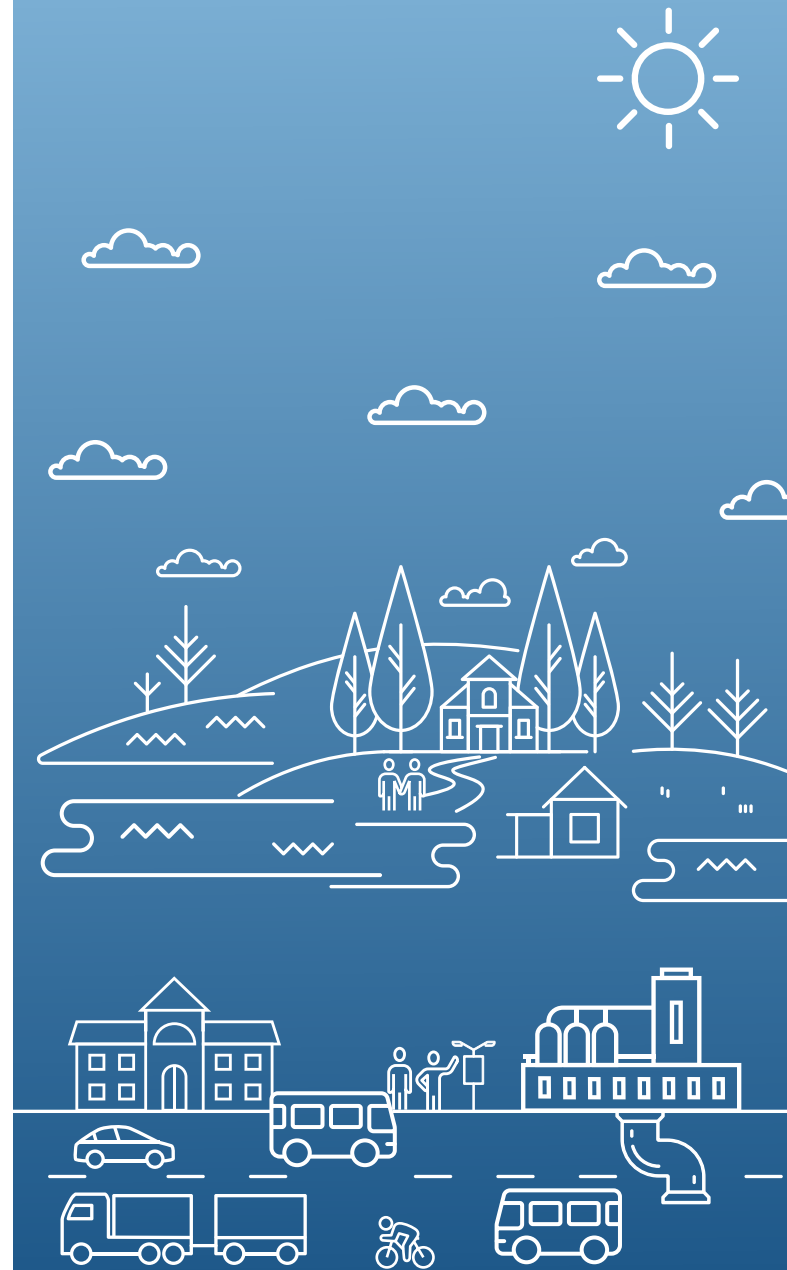
- Scottish Water has the funding it needs to continue to deliver a flourishing and improving aquatic environment, and drinking water to be proud of.
- The investment will ensure that Scottish Water's assets, such as its pipes and sewers, are better able to withstand future unexpected events.

A GREENER SCOTLAND:

- Scottish Water has the funding it needs to deliver the first phase of its ambitious net zero emissions target for 2040.
- It is also being supported to provide wider benefits for customers and communities, and to provide additional benefits such as access to land for leisure.

A MORE PROSPEROUS SCOTLAND:

- We are allowing for significantly increased investment in a major Scottish industry that improves infrastructure, creates jobs and supports livelihoods across Scotland.
- Scottish Water is – and will continue to be – a financially sustainable business and an exemplar model of public ownership on the international stage.



DEVELOPMENTS SINCE THE DRAFT DETERMINATION

There have been a number of developments since we published our draft determination, particularly in relation to additional assistance for water and sewerage customers. These developments, along with the consultation responses we received on our draft determination, have been taken into account in the final determination.

CONSULTATION RESPONSES

We received 11 responses to the draft determination from stakeholders and members of the public. We reviewed each response carefully and the main emerging themes are outlined below. All of the responses are published in full on our website: [watercommission.co.uk/view_Consultation_Responses.aspx](https://www.watercommission.co.uk/view_Consultation_Responses.aspx).

A number of the responses recognised that there was a need for increased investment to meet the future challenges that Scottish Water faces, and that this would need to be appropriately funded. There was general support for Scottish Water's transition to net zero emissions by 2040.

One respondent noted that increased investment could involve increased consumption of natural resources, and it will be important to ensure that Scottish Water takes a sustainable approach to investment delivery.


There was positive endorsement of the inclusion of social, natural and financial capital when appraising and prioritising investment. In addition, the proposal to establish a ring-fenced allowance to help accelerate the transition to the inclusion of natural and social capital in decision making was welcomed, although it was noted that it would be beneficial if there were greater clarity about how the allowance would be used. We have set out below further details in respect of this allowance.

Several respondents raised concerns about the affordability of charge increases for households and businesses, particularly in light of the financial impact of the Covid-19 pandemic. We understand these concerns and are pleased to note that the Scottish Government is providing greater protection to those least able to afford water charges through the changes announced to the water charges reduction scheme. We have also set out elsewhere in this document the measures currently in place, and now being extended, to assist businesses at this difficult time.⁸

One respondent highlighted ongoing local service issues and questioned the need for price increases. In preparing a Strategic Review of Charges, we carefully review performance and identify areas for improvement. Investment prioritisation was one obvious such area. The investment prioritisation process introduced for the next regulatory period should help ensure priority service issues are addressed. Our draft determination set out the case for increased prices, based on an analysis of the investment required to meet the Objectives set by Ministers.

The respondent also sought more oversight of Scottish Water's operations and an interim review of their performance in delivering the determination. The draft determination set out our approach to ensuring that Scottish Water provide open and transparent reporting of their performance and we will be monitoring this carefully. As discussed later in this document, the methodology for the next price review will be developed before the mid-point of this regulatory control period in 2023. The development of a methodology for a future Strategic Review of Charges requires a careful assessment of Scottish Water's initial performance in delivering this determination.

⁸ Letter on Measure in Response to Covid-19_1.pdf ([watercommission.co.uk](https://www.watercommission.co.uk))



One respondent felt that the transition to net zero should be funded by government rather than water charge payers. In this regard, we would note that Ministers' Principles of Charging, which set the charging policy for the industry, are clear that the cost of delivering Ministers' Objectives should be recovered from the customer base, with support from government borrowing.

We have also received feedback that it was not sufficiently clear from the draft determination whether or not charges could be higher than the cap in some years. We want to clarify that the CPI+2% charge cap is the annual average over the period⁹. It is for Scottish Water to decide how to phase charge levels, based on the outcome of their national conversation.

One respondent raised the issue of a lack of support provided by Scottish Water for communities seeking improvement in private water and sewage supplies. Although private supplies do not fall within our statutory remit, we recognise the need for cost effective provision of services to rural communities and note the requirement on Scottish Water to support the Scottish Government's objective of ensuring reliable and sustainable rural waste and water services.

Respondents were supportive of the view that Scottish Water needs to undergo a major transformation in its business, although the point was also made that this should not prevent

Scottish Water from making timely progress in addressing investment needs. In terms of the general regulatory framework respondents were supportive of the move to Ethical Business Regulation and Ethical Business Practice, indicating that there is more work to be done to embed this approach further.

FINAL OBJECTIVES AND PRINCIPLES OF CHARGING

Turning now to other developments since the draft determination, the Scottish Government published its Principles of Charging and Final Objectives for the sector on 7 December. Importantly, the Principles of Charging indicated an increase in the discount that is available through the water charges reduction scheme to 35%.

The Scottish Government has also broadened the coverage available so that more customers will be eligible for this assistance. This means that charges for those in receipt of the full support will see price increases below inflation over the 2021-27 period.

SCOTTISH WATER'S CUSTOMER ENGAGEMENT ON PHASING OF CHARGES

As our draft determination explained, we have sought to maximise Scottish Water's scope for flexibility in preparing its annual Scheme of Charges. In this regard, we welcome Scottish Water's commitment to engaging directly with customers through a national conversation as

⁹ *Scottish Water's Scheme of Charges will have to reflect changes in the customer base from the modelling assumptions used for this determination. These assumptions are unchanged from our February 2020 decision paper.*

part of its annual Scheme of Charges proposals. We also understand that Scottish Water has already started research into customers' views of price levels for next year (2021-22), taking account of the inevitable impacts of the Covid-19 pandemic.

CLARIFICATION OF THE RING-FENCED FUND

Our draft determination proposed that there should be a ring-fenced fund of £133m (now finalised as £132m) to enable Scottish Water to evidence where it has incurred additional costs in selecting an option that has a higher NPV than the lowest financial cost option, after allowing for externalities such as carbon, natural and social capital. Following the draft determination, it became clear that it would be helpful to clarify further the nature and purpose of the fund.

Our discussions with SEPA confirmed that the fund's objective (that decisions should consider all relevant capitals – such as natural, social and financial capitals) is aligned with SEPA's 'One Planet Prosperity' strategy. Indeed, the primary aim of the ring-fenced fund is to provide a further incentive for Scottish Water's asset managers to make the paradigm shift towards making the best decisions for One Planet Prosperity over the long term.

Both SEPA and the Commission recognise that delivering Scotland's water sector vision and Scottish Water's Strategic Plan will require Scottish Water to make informed, effective and evidenced decisions on their investment choices. These decisions must consistently strike the right

balance for a flourishing Scotland, by considering environmental, social and financial costs and benefits – ultimately through full and well-evidenced quantification. We expect Scottish Water to demonstrate its progress in this area well before we publish our methodology for the next Strategic Review of Charges.

We recognise that changing both the decision-making processes and the cultural practice within Scottish Water (and its delivery partners) will require a major transformation. As with any such transformation, this will take time to implement fully. We have recently written a joint letter with SEPA to Scottish Water confirming our expectations and the role of the ring-fenced allowance in supporting this transformation (see Appendix 1).

FINANCIAL MODELLING CHANGES SINCE THE DRAFT DETERMINATION

There have been a number of minor changes to the financial parameters that we use in setting our charges.

- The extension of the water charges reduction scheme noted above will reduce Scottish Water's revenue by just over £80m over the regulatory control period. Based on the previous draft of the Principles of Charging, we had allowed for half of this reduction in revenue in our draft determination.
- We now know that the inflation rate for October's Consumer Price Index that will be used in setting prices for the 2021-22 financial year is 0.7%.

- The Scottish Government has increased the borrowing it will make available to Scottish Water by £10m to £1,030m.
- Since the draft determination, Scottish Water has reported its financial performance for 2019-20. We have therefore updated our forecast of Scottish Water's annual revenue for 2020-21 based on this more recent information. We recognise that some uncertainty remains as to the rate at which the household and non-household customer base may change during the regulatory control period so will continue to monitor this carefully.

Our analysis indicates that the combined effect of these changes is such that the allowed level of investment for the 2021-27 regulatory control period can be maintained at £4,507m¹⁰ and the maximum amount of charges that Scottish Water can levy on its customers can remain at CPI+2% on average for each year of the regulatory control period¹¹. We have reduced the level of revenue that we would expect Scottish Water to achieve by the 2026-27 financial year by £1m to £1,433m.¹²

¹⁰The revenue figures provided in the document are in 2018-19 prices while, for comparison purposes, investment figures are provided in 2017-18 prices.

¹¹Scottish Water's Scheme of Charges will have to reflect changes in the customer base from the modelling assumptions used for this determination. These assumptions are unchanged from our February 2020 decision paper.

¹²The revenue figures provided in the document are in 2018-19 prices while, for comparison purposes, investment figures are provided in 2017-18 prices.

DELIVERING THE DETERMINATION

THE TRANSFORMATION REQUIRED

This final determination is underpinned by the expectation that Scottish Water will undergo the fundamental transformation necessary to deliver its part in the long-term vision set out in its Strategic Plan. Scottish Water should continually seek to deliver at a level that exceeds the expectations of its regulators and the customers and communities it serves.

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 to justify fully its investment needs. This approach is very different from that of previous regulatory control periods in that our expectation is that Scottish Water will evidence its progress on an ongoing basis to the customers and communities that it serves, and our reporting of their performance will reflect their success in doing so. This is at the heart of Ethical Business Practice (EBP).

Our Decision Papers and draft determination explained the approach that underpins Ethical Business Regulation (EBR) and set out our expectations of the EBP that is expected of Scottish Water. In summary, we expect 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; and
- embrace these challenges as an opportunity – and be seen to do so in a positive and constructive way.

At the same time the Commission is clear that it has an important role to be fair but frank in judging and evidencing its assessment of Scottish Water’s performance. It will support, where the evidence is good, Scottish Water’s plans for meeting the expectations of the customers and communities it serves.

As such, we anticipate that we will provide strategic commentary on performance, informed by the insights that we gain from stakeholders, customers and communities. Inherent within such an approach is a shift away from the traditional regulatory cycle, with the focus being much more on long-term planning and decision-making.

Work has already started jointly with Scottish Water to effect the transformation, including through the work with external innovative thinkers to identify improvements to the approach to appraisals which will underpin the move to better decision-making. We are also pleased to note that Scottish Water is leading on its engagement with customers and communities through the interim customer group and through the national conversation.

There are already signs that Scottish Water, the Commission and other stakeholders are benefiting from the opportunities that EBR and EBP provide, and we look forward to continuing to support Scottish Water as it seeks to make the necessary transformation within its organisation over the coming months and years.

TIMELINE AND NEXT STEPS

Our final determination takes into account the representations we received on the draft determination as the final stage in our Strategic Review process.

Scottish Water must now decide by 8 February 2021 whether or not it will accept the final determination. It will publish its Scheme of Charges for 2021-22 before the end of February 2021. The timeline for the remainder of the Strategic Review of Charges is set out below.

Remaining Strategic Review milestones	Expected dates
Scottish Water decides whether or not to accept the final determination	February 2021
Scottish Water submits its 2021 Scheme of Charges to the Commission for approval	February 2021
Scottish Water submits its 2021 Delivery Plan to the Scottish Ministers for approval	March 2021

This Strategic Review of Charges and the final determination mark only the beginning of the transformative journey that the sector will need to make in order to transition to a sustainable sector.

As such, and given the progress to date, we have set out here our initial timetable for future action and the next Strategic Review (SRC27).

This will include an assessment of Scottish Water's progress in delivering the requirements set out in this final determination. The extent of Scottish Water's progress will have a direct bearing on our approach to SRC27.

Next key milestones	Provisional dates
Annual approval of Scottish Water's Scheme of Charges	From February 2021
OECD Peer Review findings	Summer 2021
Scottish Water's first draft of its Transformation Plan	Autumn 2021
Regular commentary on Scottish Water's performance and transformation	From 2021
Develop our approach for SRC27	From the final quarter of 2021
Publish our methodology	Spring 2023
Publish information/consultation papers	From early summer 2024 to early 2026
Publish the draft determination	Beginning of June 2026
Publish the final determination	Beginning of October 2026

APPENDICES

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APPENDIX 1: JOINT SEPA/COMMISSION LETTER TO SCOTTISH WATER CONCERNING THE RING-FENCED FUND



26 November 2020

Douglas Millican
Chief Executive
Scottish Water
Castle House
6 Castle Drive
Dunfermline
KY11 8GG

Dear Douglas

Strategic Review of Charges (SRC) 2021-27: Ring-fenced Fund to enable the best decisions

Both SEPA and the Commission recognise that delivering Scotland's water sector vision and the Scottish Water Strategic Plan will require us all to make the best decisions every time. These decisions must consistently strike the right balance for a flourishing Scotland, by considering environmental, social and financial value.

We recognise that this will require major transformation to change both the decision-making processes and cultural practice in Scottish Water and its delivery partners. All of the stakeholders in the water industry sector including SEPA and WICS recognise that, to make the necessary improvements in decision making, we will jointly need to overcome any institutional barriers and historic attitudes which may persist and could have, on occasion, previously resulted in less good outcomes.

Given the urgency of addressing the climate emergency, the biodiversity crisis and Scottish Water's ageing asset base, both SEPA and WICS see a need for Scottish Water to move quickly to improve decision making processes on investment priorities and option selection. Consistent with the expectations set out by WICS in the Draft Determination, SEPA has expressed its desire to see Scottish Water transition to decision-making which will contribute to 'One Planet Prosperity'; helping communities and businesses thrive within the resources of our planet as soon as possible.

To support and accelerate this change, WICS's Draft determination has identified a ring-fenced fund to enable Scottish Water to evidence where it has incurred additional costs in selecting an option that has a higher net present value (NPV) than the lowest financial cost option, after considering all relevant capitals – such as natural (including greenhouse gas emissions), social and financial capitals.

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The primary aim of the ring-fenced fund is therefore to signal this paradigm shift towards making the best decisions for One Planet Prosperity over the long term.,

We are, therefore, clear that the £133m fund in this determination is not a cap on spending to deliver One Planet decisions. Other funds allowed for in this determination may also be used for a similar purpose, as Scottish Water considers appropriate. The use of the £133m fund (and any additional funds) should be fully justified and transparent through investment appraisals.

We recognise that SEPA and WICS have a role to play in supporting Scottish Water to make this transition. SEPA has already been working closely with Scottish Water for the past year under the SEPA/SW Sustainable Growth Agreement on the One Planet choices project, which has been developing a decision-making support framework to meet this very challenge. WICS has also been working closely with Scottish Water and Bryan Adey to identify improvements to the approach to appraisals.

We welcome Scottish Water's commitment to improve the decision-making processes as a key element to delivering Minister's objectives for the industry and the water sector vision.

It would be helpful if Scottish Water could respond to confirm its understanding of the role of the ring-fenced fund as set out above and, more broadly, provide confirmation of its approach to improving One Planet decision making processes across the organisation.

Yours sincerely

Alan D A Sutherland
Chief Executive, WICS

Terry A'Hearn
Chief Executive, SEPA

cc: SAG Group members

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APPENDIX 2: LETTER TO RETAILERS AND SCOTTISH WATER ON THE NON-HOUSEHOLD MARKET



Date: 13 November 2020

Dear Stakeholder:

Measures in support of the retail market in light of the current pandemic

The Covid-19 pandemic has had, and is likely to continue to have, material impacts on customers, businesses and the wider economy. In light of this, in March 2020 the Commission implemented [steps](#) to protect customers affected by the pandemic and to support licensed providers during these challenging times.

Since the outbreak of the pandemic, the Commission has been pleased to see licensed providers and Scottish Water working together to ensure that affected customers could benefit from a partial deferral of their water charges and receive a refund of pre-paid monies. In line with the principles of Ethical Business Practice, some licensed providers have also pro-actively offered affected customers payment plans and revised payment arrangements. Since March 2020, Scottish Water has also supported licensed providers by suspending the two-month wholesale prepayment requirement on licensed providers. In light of Scottish Government's social distancing and business restriction measures, the Central Market Agency has also suspended all licensed providers' performance standard charges and waived two months of the Central Market Agency charges.

The Commission is now consulting with stakeholders on steps to transition the market back to its normal operations and to ensure that the lessons learnt during this pandemic are used to improve the market framework. This crisis has brought into focus the need to ensure that the water industry is appropriately resilient and that retailers are able to cope with unexpected shocks. It is, therefore, important, to consider how we can ensure that market participants are in a financially sustainable position and that the market is well placed to meet future challenges.

As we consider how to phase out the current support measures, we are mindful of our statutory duties to ensure an orderly functioning of the market and that there is no detriment to the wholesale business of Scottish Water. During this transition period, it is also important to preserve the operation and integrity of the market and to provide certainty to businesses. To this end, the Commission wants to ensure that the unwinding of the current support measures is done in a measured and proportionate manner. Given the uncertainties of the Covid-19 pandemic and in order to provide all stakeholders with sufficient time to consider the issues highlighted in this letter, the Commission is extending current support measures for another two months. The deferral scheme and the suspension of the prepayment of wholesale charges due by licensed providers will, therefore, last for an additional two months, until the end of February 2021.

This letter sets out a two-month extension of the current support measures and the Commission's views of the issues that it should consider in light of the pandemic. The Commission welcomes stakeholders' initial views on these issues and suggestions of any other issues that the Commission should consider. We expect market participants to review all the questions raised 'in the round' and to contribute in a constructive manner to the consultation.

Please provide any comments in response to the questions raised in Section 2, Section 3 and Section 4 of this letter, along with any other issues that you believe the Commission should consider. Responses should be sent to competitionteam@watercommission.co.uk by 22 January 2021.

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Section 1. Temporary extension of the existing support measures in response to the pandemic

In line with its primary duties to promote the interest of customers and to ensure there is no detriment to the core business of Scottish Water, the Commission implemented support measures following a set of guiding principles:

- Businesses and other organisations impacted by the current crisis benefit fully from the scheme;
- The arrangements are sufficiently flexible that they can be adjusted or extended if required;
- There is no cost or detriment to household customers as a result of the support that is being provided to businesses and other organisations; and
- The arrangements can be unwound in a manner that does not increase the burden on businesses and organisations when they start to recover from the crisis.

In light of these principles and given the current uncertainties of the pandemic, the Commission is taking steps to ensure that customers and licensed providers continue to receive support throughout these challenging times. The Commission is, therefore, extending the deferral scheme until 28 February 2021. This will provide stakeholders with sufficient time to consider the questions raised in this letter before the current support measures are fully unwound.

Under this extension, customers will continue to be able to access the scheme via their licensed provider without paying any interest on the deferred amounts. Licensed providers will continue to access the wholesale deferral scheme and will be required to pay interest to Scottish Water on the balance of deferred wholesale charges. Scottish Water will also continue to suspend the two-month prepayment requirement of wholesale charges due by licensed providers.

This short extension will provide customers affected by the pandemic with the possibility of an additional deferral without compromising the interest of future customers. Licensed providers will also be able to take advantage of the scheme by managing the potential bad debt risk for an additional two-month period and to benefit from an additional suspension of wholesale prepayments. The table below summarises the timescales for this temporary extension to allow full consideration of the questions set out in this letter.

Measures	Original date	Revised date
Retail deferral scheme	31 December 2020	28 February 2021
Repayment by customers of deferred retail charges	From March 2021 to February 2022	From March 2021 to May 2022 ¹
One-month wholesale prepayment	February 2021	April 2021
Two-month wholesale prepayment	May 2021	July 2021

¹ Unless customers actively agree with their licensed provider to repay deferred charges over a different repayment period.

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APPENDIX 2: LETTER TO RETAILERS AND SCOTTISH WATER ON THE NON-HOUSEHOLD MARKET



Section 2. Support measures in response to the Covid-19 pandemic

Before determining the potential timescales for a further extension or unwinding of current support measures beyond the temporary extension set out in Section 1, the Commission is seeking stakeholders' views on the following questions to phase out the support in a proportionate manner:

1. How should the Commission revise the current support measures to customers and licensed providers in light of the current pandemic and having regards to its statutory duty to ensure that there is no detriment to Scottish Water and that the interest of current and future customers is promoted?
 - a) Given our duties and to support the orderly functioning of the market, when should we consider reintroducing the two-month wholesale pre-payment due by licensed providers?
 - b) When should the deferral scheme be unwound? Should we consider a further extension of the current scheme beyond February 2021?
 - c) Could the current scheme remain in place for specific categories of affected customers? How could the scheme be improved to ensure that customers receive appropriate support having regard of the interest of future customers?
 - d) Are there any other issues that the Commission should consider?

Section 3. Questions on future proofing the retail market

In light of the current pandemic and in line with its statutory duty to promote the interest of customers and orderly functioning of the market, the Commission wants to ensure that licensed providers have the appropriate financial strength to perform their licensed activities. This includes ensuring that licensed providers can also deal with unforeseen external shocks. The Commission is, therefore, seeking stakeholders' views on the following questions:

2. How can we ensure that the market continues to operate effectively and that licensed providers are (and remain) financially resilient?
 - a) How can the Commission ensure that licensed providers have and retain the appropriate financial strength to withstand external shocks?
 - b) What test and evidence could be required to allow licensed providers to demonstrate appropriate financial strength?
 - c) How often should this be required from licensed providers? Could the Market Health Check be used to ensure that licensed providers are appropriately capitalised and retain the necessary financial strength to meet future challenges?
 - d) What would be a reasonable transition period to introduce such measures?
 - e) Are there any other issues that the Commission should consider?

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In light of the current pandemic, the Commission also wants to ensure that customers are not unfairly disadvantaged nor exposed to any detriment by the activities of licensed providers operating in both the English and Scottish market. The Commission is, therefore, seeking stakeholders' views on the following questions:

3. How could we improve the transparency between the activities of retailers operating in both the English and Scottish market to ensure that customers are appropriately protected?
 - a) Should the Commission consider introducing reporting requirements on licensed providers to ensure appropriate cost allocation across the English and Scottish operations?
 - b) What form of regulatory accounting separation between retail activities undertaken in Scotland and those undertaken in England could be introduced? How could the reporting be monitored effectively?
 - c) What would be a reasonable transition period to introduce such measures?
 - d) Are there any other issues that the Commission should consider?

Section 4. Disconnections

In 2018, the Commission introduced temporary disconnections² for customer non-payment at the request of licensed providers in addition to the permanent disconnection process. These changes were introduced to support licensed providers in the implementation of water charging at vacant premises in line with Scottish Government's [Principles of Charging](#) for the 2015-21 period.

Since the outbreak of the pandemic, Scottish Water has reviewed the arrangements around disconnections for non-household premises. As a result of this, licensed providers have not been able to request a temporary disconnection due to customer non-payment.

In light of this, the Commission plans to undertake a comprehensive review of the disconnection arrangements and consider any necessary changes to the current processes at the end of the pandemic. The Commission is, therefore, seeking stakeholders' views on the following questions:

4. a) What improvements could be made to the temporary and the permanent disconnection processes and, more generally, to the Commission's Disconnections Document³?
- b) What changes should we consider making to the market framework to ensure that licensed providers can pursue customer non-payments effectively having regard of our duty to promote customers' interest?

² <https://www.mygov.scot/water-charges-vacant-properties/>

³ [Disconnections Document](#)

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APPENDIX 2: LETTER TO RETAILERS AND SCOTTISH WATER ON THE NON-HOUSEHOLD MARKET



Next steps

The Commission will work alongside Scottish Water, licensed providers and the Central Market Agency to ensure that the Wholesale Charges Deferral Scheme measures in response to the Covid-19 pandemic are extended for another two months.

The Commission will also arrange a workshop in December 2020 with all market participants to discuss in more detail the issues included in this letter and will set up an industry-wide group to discuss next steps in January 2021.

A handwritten signature in black ink, appearing to read "Alan D A Sutherland".

Alan D A Sutherland
Chief Executive

APPENDIX 3: GLOSSARY OF TERMS

Key terms	Definition
Asset	An item of economic value that Scottish Water owns to help it provide services to current and future customers. They can be physical, such as a network of water pipes and treatment works, or intangible such as intellectual property.
Charge cap	A limit on the charges that Scottish Water can levy on its customers.
CAS	Citizens Advice Scotland.
Charges scheme	The way in which Scottish Water proposes to charge customers for the services it provides for the following financial year. These charges must be in line with Ministers' Principles of Charging and within the limits set by the Water Industry Commission for Scotland in its Final Determination.
CPI	The consumer price index measures the proportional change in the weighted average prices of a fixed basket of goods and services which a household typically purchases. Changes in CPI are used to measure price changes associated with the cost of living.
DWQR	Drinking Water Quality Regulator.
EBP	Ethical Business Practice.
EBR	Ethical Business Regulation.

Key terms	Definition
Embodied carbon	The carbon dioxide or greenhouse gas emissions associated with the manufacture and uses of a product or service. We take this term to be wider than the term 'embedded' as it allows for the consideration in decision taking of the implications of potential asset decommissioning.
Financing	How the upfront investment is paid for. This may involve, for example, borrowing money to meet investment needs or letting a contract (such as a PFI contract).
Funding	Compared to financing, funding is about who ultimately pays. Such funding can only come from the customers of the service (current and future) or from the tax payer (by way of grants from government).
Investment appraisal	Examining the costs and benefits of an intervention.
Retailers	Suppliers who operate in the non-household retail market, competing for the custom of non-household customers in Scotland.
Natural capital	Elements of nature that directly or indirectly produce value to people, including ecosystems, species, freshwater, land, minerals, the air and oceans.
Net present value	The net present value of a project is the total benefits achieved over the life of the project minus the total costs, discounted at an appropriate rate.

APPENDIX 3: GLOSSARY OF TERMS

Key terms	Definition
Net zero emissions	The state at which any emissions emitted by a company are offset by the removal of an equivalent amount of greenhouse gases from the atmosphere.
OECD	Organisation for Economic Cooperation and Development.
Operating expenditure	Ongoing, day-to-day costs required to keep a business running.
Operational carbon	Greenhouse gas emissions produced during the lifespan of an asset as a result of its operations.
PFI	Private Finance Initiative contracts. A means of financing public sector projects. There are forms of such contracts but these typically involve a private provider providing an asset or service in return for regular payments over the duration of the contract.
Real terms	Values expressed excluding the impact of inflation.
Regulatory control period	The 6-year period over which WICS sets prices for water and sewerage services.

Key terms	Definition
Resilience	The ability to withstand/recover from unexpected changes without adverse effects.
Revenue	Income generated from collection of water and sewerage charges.
Ring-fenced allowance	An allowance which is for a specified purpose and provided certain conditions are met.
SEPA	Scottish Environment Protection Agency.
Social capital	Social capital is commonly used to describe the relationships and building of trust that help contribute to the success of businesses.
SRC	Strategic Review of Charges.
Tier 1 expenditure	Tier 1 refers to Scottish Water's recurring costs such as operating costs, interest payments, the cost of the legacy PFI contracts, an allowance for repair of assets and payments to developers for connecting new properties.

10 DECEMBER 2020

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