



Innovation and Collaboration:

future proofing the water
industry for customers

Methodology for the
Strategic Review of
Charges 2021-2027

About this document

One of the main ways in which we promote the interests of customers is by setting limits on the prices they pay for water and sewerage services. This process is called a Strategic Review of Charges (or price review).

This document outlines our approach for the next Strategic Review of Charges, which covers the six-year period 2021-27. In particular, it explains the changes that have been put in place to ensure that the Scottish water industry is equipped to face the challenges of the future so that customers in Scotland continue to receive high-quality services at a reasonable price.

Many of these changes build on developments initiated at the last price review in 2014¹. They were developed through consultation with Scottish Water, the Scottish Government, Citizens Advice Scotland (CAS), the Scottish Environment Protection Agency (SEPA) and the Drinking Water Quality Regulator (DWQR). The Commission is grateful for their input.

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The Strategic Review of Charges
2015-21: Final determination,
Water Industry Commission for
Scotland, November 2014.

Preface

This methodology sets out how the Water Industry Commission for Scotland intends to complete the Strategic Review of Charges 2021-2027 (Strategic Review). It takes careful account of the Commissioning letter from the Scottish Government².

Our methodology builds on the success of the Customer Forum in agreeing Scottish Water's Business Plan at the last Strategic Review. The Customer Forum worked effectively with Scottish Water to ensure that the interests of customers were at the heart of the agreed Business Plan.

For 2021-27, we plan to go further. This methodology sets out the direction of travel: for Scottish Water to look beyond compliance and meet the needs and expectations of the customers and communities it serves. We expect Scottish Water to take full ownership of its Business Plan. It should seek to build the trust of its customers, communities and other stakeholders but recognise that trust is built upon transparency, co-operation, candour and consistency. The Commission and other stakeholders will be watching carefully.

The Customer Forum will have a broader remit and an increased budget for the Strategic Review of Charges 2021-27. The Commission, Citizens Advice Scotland and Scottish Water have asked the Customer Forum to reach out to communities across Scotland in order to understand their priorities. The Customer Forum will also work with Scottish Water to seek to apply behavioural insights to the improvement of customer service and our understanding of what customers want. The Commission is again minded to accept a Business Plan, agreed between Scottish Water and the Customer Forum and consistent with the Ministers' objectives and acceptable ranges set by the Commission, as its Draft Determination.

The methodology sets out a timeline for the review. It is iterative and, as such, allows the approach to setting prices to take full account of new information and better understanding in a timely fashion. Customers and communities can reach out to the Customer Forum by email customerforum@watercommission.co.uk or by post, care of the Commission.

The methodology sets out an approach which, we trust, will allow for a quality conversation about the opportunities and challenges that the Scottish water industry faces and the best ways to address them. For example, how should Scottish Water manage its assets both now and into the future?

The stakeholders in the Scottish water industry have asked the OECD to observe the process of setting prices for the next regulatory control period. The OECD will interview each of the stakeholders at regular intervals and publish lessons learned after the Strategic Review of Charges 2021-27 has been completed (likely to be in 2020).

We look forward to working closely with Scottish Water, the Customer Forum, SEPA, DWQR, Citizens Advice Scotland (CAS) and other stakeholders throughout this Strategic Review.

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See Appendix 1

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Key steps in future proofing the water industry

Scottish Water should seek to build the trust of its customers, communities and stakeholders – both as a service provider and as a good corporate citizen.

Scottish Water should expect that its approach and its evidence will be scrutinised carefully.

Building on success

The Scottish water industry has come a long way in the 15 years since Scottish Water was established. Levels of service have improved; unit costs have been cut by some 40% in real terms and over £7.5 billion has been invested. But there is no room for complacency! Scottish Water can take greater ownership of its strategy. It can become more innovative; more responsive to its customers and become an even better member of the communities it serves.

‘SRC 2015-21: Innovation and Choice’ was a first step. It freed Scottish Water to consider innovation on its merits. It also offered Scottish Water the opportunity to discuss and agree its business plan directly with a Customer Forum.

‘Innovation and Collaboration’ now goes further. It expects Scottish Water to justify how it spends customers’ money and how it serves communities. In short, Scottish Water should “Seek trust – but expect verification” and look beyond compliance.

The role of markets

The non-household retail market appears to be working well. As the Scottish market matures, and an English retail market opens, the Commission has taken a number of steps to ensure that Scottish Water cannot be adversely affected by the market arrangements in Scotland or South of the border.

The Commission considers that there could be only very limited scope to extend the use of markets in the water sector. Challenging Scottish Water to justify fully to its customers the actions and choices that it makes will likely be more effective. The transparent reporting of its financial performance will bring greater benefits to customers.

Seek Trust

Scottish Water should engage closely with its stakeholders and provide robust evidence to support its plans. In so doing, Scottish Water should be allowed the space to be honest about the quality of its information and to be clear where it is relying on judgment rather than hard evidence. It should explain clearly the extent and implications of the efficiency challenge that it has set itself. It will, for example, publish appraisals that will provide reassurance that it has thought carefully about what, when and how it is acting to deliver benefits to customers and communities.

Future proofing the water industry

Customers often take their water and wastewater service for granted. Customers assume that the network is being appropriately maintained. There should not be any need for a sudden increase in charges in the future to correct for under maintenance of assets today.

Scottish Water could reasonably be expected to make steady progress towards a comprehensive and shared understanding of risks and asset conditions.

Scottish Water will consequently have to consider carefully how it should manage its finances and funding so that it will be well placed to meet the challenges of the future.

Our most customer-centric price review!

The Customer Forum for 2021-27 will begin work on 15 May 2017. Peter Peacock CBE will again chair the Forum. The Forum will benefit from an increased budget, support from the OECD and an extended remit to consider the needs of communities as well as customers.

Scottish Water should expect that both the Commission and the Customer Forum will look at its plans carefully. Our intention is to create a regulatory framework in which Scottish Water will take the initiative to provide robust evidence that it is delivering for its customers.

During the next regulatory control period, Scottish Water's Board will identify how much of its outperformance can be shared. It will work with the Scottish Government and the Customer Forum to decide how best to use any such resources.

What will success look like?

Scottish Water will be a water company that achieves excellence in serving its customers. It will be a respected and admired member of its communities.

Scottish Water would, for example, contribute actively to the circular economy and will continue to reduce its carbon footprint. It will be financially sustainable in both the short and long term.

There will be a high degree of trust and collaboration between stakeholders. Scottish Water and its regulators will work collaboratively and constructively to identify and implement the most effective and efficient solutions possible. It will look beyond compliance.

In short, the Scottish water industry will be well placed to realise the Scottish Government's ambition that Scotland becomes a Hydro Nation that manages the water environment to its best advantage and promotes efficient resource use.

A paradigm shift!

- "Innovation and Collaboration" places a clear onus on Scottish Water. Scottish Water will have to take full ownership of its strategy and its finances to demonstrate that it is focused on delivering the very best for customers and for Scotland.
- The Commission wants to empower Scottish Water. It has high expectations about how Scottish Water should operate its business and interact with its customers and communities. It considers that this approach is likely to be more effective than introducing more markets to the water and sewerage industry.
- Scottish Water and the entire Scottish water industry should act demonstrably in a manner that is fully consistent with the principles of Ethical Based Regulation (EBR). EBR establishes a supportive and collaborative environment, but carries a substantial sanction when behaviour is inconsistent with the principles of EBR.
- Scottish Water should be able to demonstrate to its customers and stakeholders that it is taking all appropriate steps to prepare for the future challenges facing the industry.
- Scottish Water will have to innovate if it is to meet the expectations of its customers both now and long into the future. There is now no regulatory barrier to innovation caused by the price setting process.
- Scottish Water should set its sights on exceeding the most demanding expectations of its stakeholders, customers and communities!

1

Introduction



Scottish Water should be ready to explain its proposals.

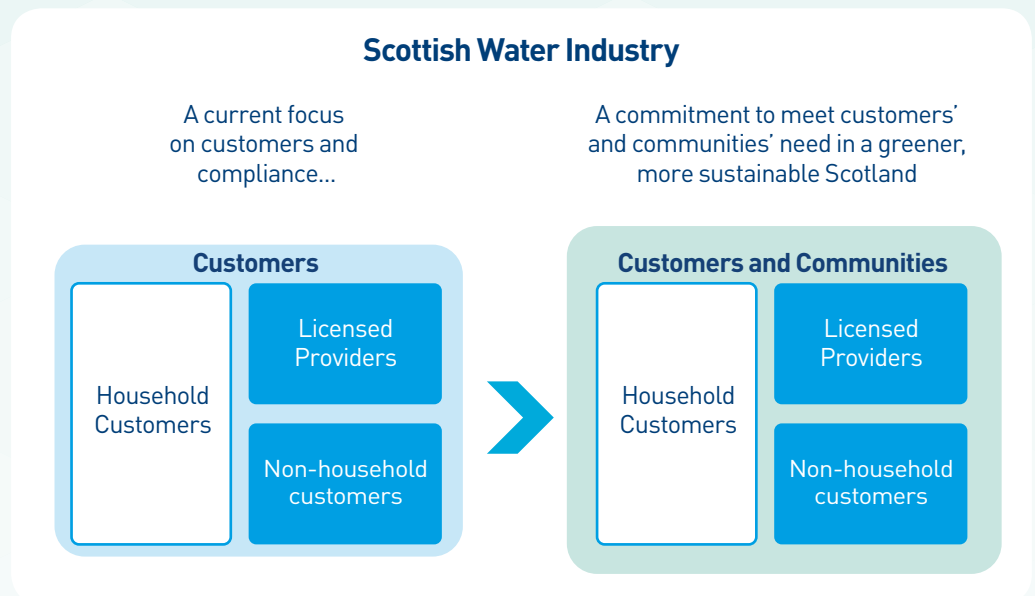
The Water Industry Commission for Scotland (Commission) will set prices for the regulatory control period 2021-27 in March 2020³. The Commission has a duty to set charges that are consistent with the lowest reasonable overall cost that Scottish Water should incur to meet the objectives set for it by the Scottish Ministers⁴.

Introduction

This methodology sets out both the timeline that the Commission intends to follow and the process that it will adopt in setting charges. The aim is to build upon the Commission's previous experience and to reflect upon the much-improved performance of Scottish Water. Our planned approach for this price review is a decisive move away from the 'parent-child' relationship of traditional economic regulation. It builds on the successful outcome of the previous Strategic Review of Charges where Scottish Water reached agreement with the Customer Forum on its Business Plan for the 2015-21 period.

We want Scottish Water to take full ownership of its strategy and its relationship with its customers. It will be for Scottish Water to take responsibility for how it meets the Government's objectives and the expectations of the Quality Regulators. It should look beyond compliance. Scottish Water should be ready to explain why its proposals are in the best interests of customers. This is no small hurdle. In short, Scottish Water should "seek trust but expect verification". This transformation of the Scottish water industry is illustrated in Figure 1.

Figure 1: The transformation of the water industry in Scotland



³ The Commission will publish its Draft Determination for the 2021-27 regulatory period in November 2019 and its Final Determination in March 2020.

⁴ The Commission also has a statutory duty to promote the interests of both current and future customers and to have specific regard to the needs of rural customers.

This methodology also outlines the enhanced role that the Commission will ask the Customer Forum to play. The Forum has an important role to act as a conduit for the views of customers.

For this Strategic Review of Charges, the Commission will again decide appropriate ranges for key variables that impact customer charges, such as capital investment levels, operating expenditure allowances and service levels. It will meet regularly with both Scottish Water and the Customer Forum. The Commission has asked the Forum to seek to agree Scottish Water's draft Business Plan within these ranges and has made it clear that, should the Forum be successful in doing so, the Commission would be minded to accept this agreement as its Draft Determination. The Commission has also asked the Customer Forum to work closely with Scottish Water to engage with different communities across Scotland. We are determined to make this our most customer-centric price review yet.



The Forum has an important role.

The Structure of the Methodology

This Methodology opened with some key messages about future proofing the water industry for customers in Scotland. There are seven chapters.

Chapter 1 is an introduction and sets out the governance of the water industry in Scotland. The Commission has, within this governance framework, sought to innovate at each price review in order to provide an effective challenge to Scottish Water. Scottish Water has responded well and improved dramatically over its first 15 years. The Scottish Government has consistently supported our approach to regulation. The Commission is grateful for the challenge and support of its stakeholders⁵.

Chapter 2 sets out the regulatory philosophy of the Commission. Scottish Water should "Seek Trust but Expect Verification". As explained earlier, the onus is on Scottish Water to demonstrate both now and on an on-going basis that its customers and other stakeholders should trust it to deliver the right levels of service for an appropriate price. This philosophy builds upon the experience of the Strategic Review of Charges 2015-21. In developing our approach to this price review, we have sought to act in a manner consistent with the principles of ethical business regulation, set out by Professor Christopher Hodges of Oxford University⁶.

Chapter 3 builds on this regulatory philosophy setting out in practical terms what the Commission plans to do to win and maintain the trust of Scottish Water and also what it expects of Scottish Water.

Chapter 4 sets out the expanded engagement role that the Commission has asked the Customer Forum and other stakeholders to play at this price review. The expectation is that the Customer Forum, alongside Scottish Water, will engage with communities across Scotland. There is also an intention to understand the priorities of different communities of interest, including those of different age groups, interests and of those with disabilities, and what may be able to be done in order to improve levels of service and Scottish Water's standing in the community.

⁵ Ofwat sets prices for customers in England and Wales. Ofwat is in the process of deciding its methodology.

⁶ Christopher Hodges has set out Ethical Based Regulation in "Law and Corporate Behaviour: Integrating Theories of regulation, Enforcement, Compliance and Ethics" Hart Publishing 2015. Christopher Hodges is Professor of Justice Systems, and Fellow of Wolfson College, University of Oxford.



Not all attempts at innovation will be successful.

Chapter 5 is an important chapter. It sets out how the Commission plans to enable innovation by – Scottish Water being open to any approach to delivering the outcomes required by the objectives of the Scottish Ministers (agreed where appropriate with DWQR and SEPA). The Commission recognises that not all innovations will be successful and even fewer innovations may be financially justified within an initial regulatory control period. The Commission expects Scottish Water to be able to evidence how its broad approach to the management of risk and innovative approaches is in the best interests of customers. It should also show that its approach is supported by its customers and the communities it serves.

Chapter 6 looks at how customers' interests can best be protected in the medium to long term. This is about how service levels can be maintained and the condition of assets be held broadly stable. This should ensure that there are less disruptions to service caused by asset failures and also that a significant backlog of maintenance is not built up for future generations of customers to deal with.

Chapter 7 is about how we will monitor the financial performance of Scottish Water. It explains the 'tramlines' approach that we introduced at the last Strategic Review of Charges. The 'tramlines' approach has been generally welcomed by all stakeholders. It provides a clear indicator as to whether Scottish Water is appropriately and sustainably funded and financed. The chapter also explains how we expect Scottish Water to manage its resources within a regulatory control period.

There are four appendices:

- The Commissioning letter for the Strategic Review of Charges 2021-27;
- The Cooperation Agreement that establishes the Customer Forum;
- The scope of work currently agreed with the OECD⁷; and
- The timeline for the Strategic Review of Charges 2021-27.

The governance of the water sector in Scotland

The roles of the Scottish Government, Scottish Water and the other organisations or groups involved in a Strategic Review of Charges are set out below. These roles are clearly defined. The different organisations respect each other and work very collaboratively.

The Scottish Government

The Scottish Government plays a central role in setting the policy and vision for the water industry and water environment in Scotland. The Scottish Government plays three distinct roles. It sets policy, acts as banker to, and is the owner of, Scottish Water.

The Scottish Government is responsible for the overall governance framework of the water industry in Scotland. Its policy role comprises several elements. It sets the policy for the water and wastewater industries in Scotland. This includes decisions on required outcomes such as water quality and compliance with European Union (EU) Directives. The policy role, however, is wider. It also involves considering a wide variety of policy areas, such as: regional policy (mandating that households living in equivalent houses should pay the same for a service irrespective of the costs of supply); fairness (who should pay what and why?); and investment in encouraging and facilitating economic growth.

An important element of the governance framework is the process of price setting. The Water Industry Commission for Scotland sets prices in a Strategic Review of Charges. Ministers set the frequency and timetable for each Strategic Review.

⁷ OECD: The Organisation for Economic Cooperation and Development was established in Paris in 1961. It has 35 members. It works with the Governments of the Member States to develop policy recommendations based on best practices.



The Scottish Government Objectives set out its view of the appropriate strategic trade-offs.

The Scottish Government asks the Commission to conduct a review for a defined period (most recently six years). The Commission must set charges that are consistent with the lowest reasonable overall cost for Scottish Water to deliver the objectives that the Government has set for it. The Scottish Government decides its objectives and its principles of charging in light of the 'Quality and Standards'⁸ process, which involves substantial consultation with all interested stakeholders. The draft (and ultimately the final) statement of Objectives sets out the Government's view of the appropriate trade-offs between different strategic priorities.

The charge caps set by the Commission also need to be consistent with the Principles of Charging. The Scottish Ministers' Principles of Charging sets out the charging policy of Government and the principles that should be followed in deciding the tariffs paid by customer groups for specific services. It sets out whether or not cross-subsidies should exist between groups of customers (and, if so, at what level). Ministers also identify the amount of borrowing that will be made available to the industry.

The second role of the Scottish Government is to act as the banker to Scottish Water. Scottish Water can borrow up to a limit set by the Scottish Government. In theory, Scottish Water could borrow from any lender, but the price of the borrowing provided by the Scottish Government will invariably be cheaper than any market offer⁹.

The third role of the Scottish Government is to act as the owner of Scottish Water. They appoint the Non-Executive members of the Board. The Scottish Government has a relatively light touch ownership role, through strategic engagement and regular contact at Board level. The Scottish Government is keen that Scottish Water continues to innovate and to support its Hydro-Nation initiative.

Scottish Water

Scottish Water is a publicly-owned business, answerable through the Scottish Ministers to the Scottish Parliament and to the people of Scotland. It provides water and wastewater services to households and businesses across the entire country. It operates a vast network of pipes, sewers and treatment works. It also manages water sources, water storage and the points of discharge of treated wastewater back to the environment. Scottish Water acts as the wholesaler of water and wastewater services to licensed providers, who provide retail services to non-household customers. Scottish Water provides retail services to households.

Scottish Water publishes a Delivery Plan, which sets out how it plans to meet the targets set out in the Commission's Final Determination of Charges. This plan is refreshed each year.

The Scottish Environment Protection Agency (SEPA)

SEPA is a non-departmental public body, accountable through Scottish Ministers to the Scottish Parliament. SEPA's role is to protect the environment and human health, to make sure that our natural resources and services are used as sustainably as possible, and to contribute to the ministerial goal of sustainable economic growth.

As the statutory environmental regulator, SEPA works with the Scottish Government and Scottish Water to establish the requirement for future investment in the water industry to meet environmental standards. SEPA also works with other industry stakeholders to monitor Scottish Water's delivery of the objectives set by Ministers, as well as ensuring overall compliance of Scottish Water's activities (such as discharges to both groundwater, surface water and to water abstractions).

⁸ The Quality and Standards process for 2015-21 is described on the Scottish Government's website at www.scotland.gov.uk/Publications/2012/06/3533/downloads

⁹ Even the EU's European Investment Bank will not be able to compete on prices with the borrowing made available by the Scottish Government.



Stakeholders must consider the representations of Citizens Advice Scotland.

The Drinking Water Quality Regulator (DWQR)

The DWQR is the statutory regulator for drinking water quality in Scotland. It provides an independent check that Scottish Water is complying with the legal standards for drinking water, as set out in regulations. The DWQR has extensive powers to acquire information, conduct investigations and take enforcement action should this prove necessary.

The DWQR also works with the Scottish Government and Scottish Water to establish the requirement for future investment in the water industry to meet current and future drinking water standards. It works with other industry stakeholders to monitor Scottish Water's delivery of the ministerial objectives.

DWQR and SEPA have an important role in working with Scottish Water and Citizens Advice Scotland (CAS) to define the work that is required to achieve the ministerial objectives. We refer to the DWQR and SEPA as the Quality Regulators in the remainder of this document – unless we are specifically referring to one of them.

Citizens Advice Scotland (CAS)/The Consumer Futures Unit (CFU)

The Consumer Futures Unit within CAS is the representative body for consumers across the regulated industries of water, energy and postal services. The CFU has a range of statutory powers and duties to enable it to act on behalf of consumers. A number of organisations (including Scottish Ministers, the Commission, Scottish Water, the DWQR and SEPA) must consult with CAS and consider its representations on behalf of consumers on water issues. CAS fulfils its role by working closely with industry stakeholders within various forums such as the Outputs Monitoring Group.

The CFU uses research and evidence to ensure consumers are at the heart of policy and that they benefit from regulation.

When setting charges, the Commission must consult CAS and have regard to any representations it makes.

The Water Industry Commission for Scotland

The Water Services Act of 2005 established the Water Industry Commission for Scotland. The Commission comprises 3-5 ordinary members (one of whom acts as Chair) and the Chief Executive of the Commission. The Commission has a statutory duty to promote the interests of customers. The Commission sets charges for water and sewerage services that are consistent with the reasonable costs incurred by Scottish Water in meeting the Scottish Ministers' objectives for water quality, environmental improvement, economic growth and customer service.

The Commission sets charges for the core business of Scottish Water – providing water and sewerage services. We do not regulate Scottish Water's non-core activities such as Scottish Water International or Scottish Water Horizons.

The Commission identified the need for a Customer Forum and agreed its remit with CAS and Scottish Water. However, under the Co-operation Agreement, the Commission retains overall control of the price determination process. It will engage with Scottish Water throughout the process and issue its decisions on the reasonable ranges for the key variables in the Strategic Review of Charges that impact customer charges, such as capital investment levels, operating expenditure allowances and service levels. The Commission is minded to accept a Business Plan agreed between Scottish Water and the Customer Forum that is consistent with these ranges as its draft determination.

The Commission monitors the performance of Scottish Water. It publishes an annual assessment of Scottish Water's performance.

The Commission also has a duty to supervise the retail market and ensure that licensed providers can participate successfully. The Commission regularly reviews the market rules and processes to ensure that there is a level playing field for all entrants. It has a statutory duty to ensure that the operation of the retail market does not do detriment to the core (wholesale) activities of Scottish Water.

In line with our responsibilities under the Water Services 2005 Act, the Commission agrees the wholesale tariffs and credit terms that Scottish Water must offer to all licensed providers. It also sets a series of default tariffs that licensed providers must offer to their customers. Licensed providers are free to offer discounts (from the default tariffs). They are also allowed to set higher prices where they offer enhanced levels of service.

The Customer Forum

Scottish Water, the Commission and CAS signed a Co-operation Agreement in February 2017 to establish a Customer Forum. The partners in the Co-operation Agreement appointed Peter Peacock CBE as chairman of the Forum. CAS, in association with the Forum Chairman, will appoint six members. Licensed Providers will appoint three members. Members do not represent any interest group or organisation and are expected to work collaboratively to achieve the best overall outcome for all customers. Under the Co-operation Agreement, the Forum is charged with reaching an agreement with Scottish Water on a Business Plan that is consistent with a series of decisions on the ranges of inputs that the Commission determines reasonable. The Commission has made it clear that if the agreed Business Plan is consistent with its decisions then it would be minded to adopt that plan as its draft determination of charges.

The Outputs Monitoring Group

The Outputs Monitoring Group (OMG) is responsible for monitoring Scottish Water's progress in implementing its delivery plan. The OMG brings together representatives from the Scottish Government, Scottish Water, SEPA, the DWQR, CAS and the Commission. The discussions at OMG ensure that there is a common understanding of progress in meeting the objectives of the Scottish Ministers. The OMG reports to Scottish Ministers on progress. This performance report is published on the Scottish Government's website.

The OMG also oversees the process by which changes are made to the detailed definition of the capital expenditure programme as a result of better information or revised priorities.

The group meets every three months.



**Guidance is binding
in Scotland.**

How the governance framework in Scotland compares with England and Wales

The governance framework of the water industry in England and Wales is, in broad terms, quite similar. There is a tri-partite regulatory framework: an economic regulator (Ofwat); environment regulator (the Environment Agency) and a drinking water regulator (Drinking Water Inspectorate, DWI). In England, the Department for Environment, Food, and Rural Affairs can give guidance to Ofwat and the other regulators, but this guidance is not binding – as it is in Scotland. The governance framework of the water industry in Wales is more similar to Scotland. There are regular meetings between the Welsh Government, Welsh Water and the Quality Regulators.



Scottish customers benefit because the company that supplies them does not pay a dividend.

The most significant difference is that the industry in England and Wales was privatised in 1989. The companies in England and Wales operate under licence. The licence documents outline the responsibilities of the companies (the obligations are broadly equivalent to the statutory obligations of Scottish Water). There are 10 regional water and sewerage companies and seven water only companies. Each of these companies is the monopoly wholesaler in its region.

A non-household retail market opened in England in April 2017.

In setting prices, Ofwat has to take account of the views of investors. All the privatised companies can borrow as much as they want from the capital markets (subject to the licence requirement that the company maintains an investment grade rating). Ofwat has a statutory duty to ensure that an efficient company is able to finance its functions (in other words retain or, if necessary, attract) sufficient financial resources to meet its obligations. The key question is, therefore, the extent of the dividend that each company is able to pay out to its owner(s). Dividends limit the amount that a company is able to reinvest to meet customers' priorities.

Welsh Water is now a not-for-dividend company and reinvests all of its profits to the benefit of customers in Wales. In economic terms, Welsh customers, like Scottish customers, benefit because the company that supplies them does not pay a dividend.

The OECD Review



The OECD will observe the entire process of the Strategic Review of Charges 2021-27.

Professor Stephen Littlechild monitored the Strategic Review of Charges 2015-21. He interviewed each of the stakeholders during the Strategic Review of Charges. He reported his conclusions at the end of the process. All the stakeholders found his observations helpful.

The Water Industry Commission for Scotland, Scottish Government, Scottish Water, CAS and the Quality Regulators were keen that the Strategic Review of Charges 2021-27 be subject to a similar review. We have therefore asked the OECD to observe this Strategic Review 2021-27. In discussing the scope of this work, it became clear that there was an opportunity to benefit more broadly from the experience of the OECD. As such, in addition to observing the Strategic Review of Charges, the OECD will advise on:

- Testing tools and approaches to engage stakeholders through behavioural insights; and
- Reviewing current approaches to capital maintenance in regulated industries.

Mapping stakeholder engagement institutions and processes

The OECD will observe the entire process of the Strategic Review of Charges 2021-27. They will conduct interviews with key stakeholders at each stage of the Strategic Review of Charges to document:

- the roles, objectives and expectations of the engagement process and the extent to which they are aligned with the expectations of the different stakeholders;
- the resources and capacity for meaningful engagement;
- the processes used for engaging with and collecting the views of customers; and
- the output and outcome of the process, including the results of the engagement process and the views of the different stakeholders on the effectiveness and efficiency of the Strategic Review of Charges.



How stakeholders may improve this engagement by applying behavioural insights.

The OECD will provide its conclusions after the Final Determination of Charges. The OECD is particularly well placed to play this role because of its work in:

- developing the Performance Assessment Framework for Economic Regulators (PAFER);
- hosting of the Network of Economic Regulators (NER);
- developing the OECD Best Practice Principles on the Governance of Regulators;
- developing the OECD Best Practice Principles for Stakeholder Engagement; and
- water governance.

Testing tools and approaches to engage stakeholders through behavioural insights

The OECD will advise on how stakeholders in Scotland may improve their engagement with customers and communities by applying behavioural insights.

At this time, it is expected that behavioural insights could be applied to:

- the way in which Scottish Water engages with stakeholders on ranges of key inputs to the price review; and
- testing different strategies for the engagement of Scottish Water and the Customer Forum with different communities.

It may also be possible to apply behavioural insights to the Scottish Government's approach to setting its Objectives.

The OECD will set up a panel of experts on regulation, stakeholder engagement and behavioural insights to provide Scottish Water and the Customer Forum with suitable advice.

The OECD team will meet with all the stakeholders in the Strategic Review of Charges process in May. The aim of this round table discussion will be to identify potential areas for testing alternative approaches in light of knowledge and experience on using behavioural insights. This could involve laboratory experiments and/or field experiments.

Scotland's Centre of Expertise for Water (CREW) has experience in behavioural insights and customer engagement. There may be scope to draw on this expertise in planning the experiments.

The OECD will publish a report on the results of the experiments, including specific recommendations for enhancing the effectiveness of engagement with stakeholders. This report will be peer reviewed at one of the meetings of the NER.

Sharing current approaches to capital maintenance in regulated industries

The OECD currently plans to facilitate a forum to look at capital maintenance both in regulated and unregulated industries. It will bring together the views of Governments, regulators and industry. The OECD will look at the forecasting of capital maintenance needs, asset stewardship and the mechanisms used by regulators and infrastructure operators to assess and provide for capital maintenance expenditure.

The OECD will also look at the engagement with stakeholders on capital maintenance, reviewing the approach adopted by infrastructure operators, economic regulators, and government.

The assistance of the OECD may change in light of the broader stakeholder discussion that is planned for May 2017.

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Regulatory philosophy

Introduction

The evidence is that the economic regulation of the water and sewerage sector in Scotland and the rest of Great Britain has worked well. Costs have fallen, service levels to customers have improved markedly and there has been considerable investment in improving water quality and our environment. Drinking water quality is at record levels. The improvement in our rivers and beaches has been similarly dramatic.

It is not, however, clear that the same approach to economic regulation that has driven these improvements over the last ten to fifteen years will continue to be as effective. Traditional economic regulation, with its relatively narrow focus on improving service standards and reducing costs, is not well suited to addressing the more complex challenges that the industry now faces. These challenges include issues such as increased uncertainty, the need to involve multiple stakeholders in identifying sustainable solutions and the timing of required expenditure. Successfully addressing these challenges will be important for both current and future customers. It will require innovation and collaboration between the industry, its customers and the wider stakeholder community. In short, it will require that regulated companies “seek trust, but expect verification”.

This chapter first reviews how economic regulators have approached their task and the challenges that the economic regulator faces today. It then sets out why this approach will need to change. The chapter sets out two alternative directions of travel and the implications of each. It concludes that success will require us to overcome the asymmetries of information inherent in traditional economic regulation. This will require better engagement between regulators, the regulated company and customers. To be effective, regulation will have to rely on open and collaborative approaches. It will have to put properly empowered customers truly at the heart of the process.

In our view, regulation should not rely on disaggregation of the industry value chain and competition – to do so can only increase the scope for asymmetries of information.

The approach of the economic regulator

The pioneers of economic regulation in the United Kingdom wanted a relatively simple and temporary framework. Their expectation was that competitive markets would develop and make economic regulation substantially redundant. The role of Government would decrease and the power of the consumer would increase significantly. Investors and customers would both benefit.

Background

These pioneers considered economic regulation to be necessary in the short to medium term in order to safeguard the interests of investors. This was because the investments required were typically very long term and there was a risk that, after the asset was delivered, Government could seek to force prices down towards their marginal costs of operation. This would have had the result that investors could not recoup their initial investment, let alone a return on capital. The pioneers believed that attracting the required levels of investment would require an explicit commitment that efficient capital expenditure would be respected and remunerated¹⁰.

The UK pioneers sought to create an incentive to encourage innovation and efficiency. Their ideas have become known as incentive based (RPI-X) regulation. RPI-X sought to establish a 'hard budget constraint', which fixed the funding available to the regulated business. The pioneers suggested that the regulated company should retain any additional surplus beyond that allowed for in the setting of prices for the duration of a regulatory control period. This framework created an incentive for regulated businesses to find more effective and efficient ways of delivering services to customers.

Despite regulators having become less willing to see temporary excess profits, the underlying incentive properties of this regulatory approach have generally served investors and customers well.

Information

The first challenge for the economic regulator in successfully establishing a 'hard budget constraint' is to understand the costs and levels of service of the regulated business. The company will always know more than the regulator about the costs and services. This difference is referred to as 'asymmetry of information'.

There is likely to be a broadly similar asymmetry between the company and its owner(s) and even within a company between its most senior management and those charged with day-to-day operations and planning.

Regulators have adopted various approaches: expanded submissions of information, audit of information returns and various types of incentive in an attempt to reduce this information asymmetry to manageable levels.



The company will always know more than the regulator about the costs and services. This difference is referred to as 'asymmetry of information'.

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Such a process could equally well occur in a publicly owned industry. In the public sector, the result would be that assets are under-maintained and that the initial debt incurred to finance an infrastructure project is never paid back. As a result future generations of tax payers have to meet the benefits afforded to preceding generations.

Looking to the future

The regulator also has to form a view about what may happen in the future. It is perhaps obvious that the regulated company will likely know more about operational, cost or service issues in the future than the regulator (for example, how long particular assets will be fit for purpose).

Regulators have successfully addressed some of the future issues that they know about. For example, the introduction of a regulatory capital value ensured that investors would be protected when they committed long term capital. However, the regulatory process has not found a satisfactory way of addressing many other 'future' issues that it knows about – let alone yet to be known issues.

Allowing funding ahead of need would likely reduce the robustness of the 'hard budget constraint' and consequently the effectiveness of regulatory challenge. This would clearly not be in the interests of customers. Arguably, the lessening of the 'hard budget constraint' is also not in the interests of the investor(s) (or, in the public sector, Government): it would most likely reduce the pressure on managers to identify opportunities to improve efficiency and to innovate.

Regulatory Capture

There is the potential for 'regulatory capture' when the regulator becomes unable to make appropriately independent judgments about a regulated company. The Commission's experience suggests that it has to be alert to any such accusation. The political process is quick to spot and seek to criticize any failures of governance or performance of a publicly owned company or its regulator.

Regulators should therefore be cautious about working with a regulated company. It is right and proper that economic regulators guard their ability to make independent judgments and avoid being pulled unnecessarily into management detail. It is not surprising that economic regulators generally prefer market solutions – effective markets do, after all, empower customers.

The Commission's experience is somewhat different. It designed and implemented the first 'in the market'¹¹ framework for competition in the water industry. To ensure that this framework was successful, the Commission understood that it would need to have an understanding of the costs, capital requirements and risks of the business activity that was to be made competitive. It worked, therefore, with Scottish Water and potential new entrants to ensure that non-household wholesale prices and retail margins were appropriate such that an efficient entrant would find it attractive to enter the non-household retail market. This joint working was, in our view, essential to the success of the non-household retail market opening. It largely eliminated the potential impact of information asymmetry. Doubtless prior to that experience, the Commission would have seen collaboration as inimical to effective regulation. It is not. Better information and improved understanding actually significantly reduce the risk of capture.



Joint working was, in our view, essential to the success of the non-household retail market opening.

11

'In the market' competition is where different entities compete on price and service to meet essentially the same broad customer needs.

'For the market' competition is where a single supplier is sought to meet a specific need by means of a tender or auction.

How regulation has evolved

Economic regulation has not given way to competition as its early pioneers had hoped. The original concept was that charges would be set on a 'top down' basis. They would reflect the efficiencies revealed by regulated companies when their actual performance was compared to past performance. There was an explicit recognition that tolerating excess profits in the short run was beneficial to customers because the economic regulator could reset prices at the start of the next regulatory control period based on the information revealed by the historic performance of the regulated company.

Quite quickly, however, regulated companies understood the powerful incentives of this approach. They began to challenge how the regulator had set the efficiency challenge. The job of the critics was made easier as there is a political cost when regulated utilities are seen to be earning excess profits.



Price setting has become much more complex.

As a consequence, price setting has become much more complex. The regulators have sought to demonstrate the reasonableness of their approach by adopting a 'bottom up' (or 'building blocks') approach, where the regulators consider and make assumptions about each element of cost and about the outputs that will be delivered. This includes an explicit consideration of the level of profit that should be allowed for. This approach has, however, increased the importance of the information asymmetry problem.

The building blocks process involves the collection of large amounts of information both by way of annual reporting and by the completion of detailed business plans by regulated companies. The regulators then seek to use this information to compare the performance of companies both in terms of their unit costs and key outputs such as levels of service. The regulators also define a return on the regulatory capital value that is considered appropriate to attract and retain capital. Quite obviously, information confers great power on owners and managers of regulated business. This power is to the potential detriment of customers.

When regulation was first introduced to the water and wastewater industry (both in England and Wales following privatization and in Scotland, following devolution), the industry was inefficient. It had high unit costs for both capital expenditure and operating expenditure. Levels of service needed to be improved. Significant capital expenditure was known to be required to meet agreed European Union water quality and environmental standards.

Given the scope for improvement – both in terms of unit costs and levels of service – the building blocks approach and the analysis of performance information and relative benchmarking worked very well. It worked principally because the differences between companies were material. The regulated companies could suggest that the precise method of assessing the efficiency challenge was incorrect, but they could not reasonably challenge that there was a gap in observed performance.

Both regulator and regulated company recognised that there were factors specific to each company that complicated comparisons. There was, however, an uneasy truce under which the regulator made some adjustments for well evidenced special factors, and the regulated company accepted the broad thrust of the efficiency assessment. The demonstrable efficiency gaps outweighed the potential benefits of the asymmetries of information enjoyed by the regulated companies.

The comparisons of relative performance brought about dramatic reductions in unit costs (to lower levels than anyone considered possible in 1989). It also resulted in very significant improvements in the levels of service to customers with continuing high levels of investment to meet European Union quality standards.

Where are we now?

Not surprisingly, the gaps in the performance of water companies have narrowed considerably over time. The likelihood is that much of any observed performance gap can now be explained by real differences between companies (not all of which either the regulator or the regulated company are likely to understand fully). As such, the traditional approach of driving performance improvement through benchmarking has become more problematic. Success in benchmarking performance faces three challenges that are now even more important than they were previously:

- Ensuring the accuracy of the information provided by the regulated companies;
- Establishing the consistency of the information between the companies; and
- The robustness of the approach to comparing performance.

The historic approach to setting prices will only be fully effective if each of these challenges can be met effectively. There are several reasons why addressing these challenges is likely to be difficult. These include:

- Different operating models can influence the information that is collected and used by a regulated business;
- The culture and time horizons of different managements and investors could influence how they provide information; and
- It is difficult to compare different combinations of costs and levels of service.

In summary, when the performance gaps narrow, increasing reliance is placed on the accuracy of the information (and the quantification of levels of service) used in the benchmarking to establish precise differences in relative performance. The scope for the regulatory framework to cope with measurement or modelling error is significantly reduced.

Potential mitigations

The use by the regulator of an explicit allowance for special factors¹² was an example of a mitigation introduced because all stakeholders recognised that there were differences between regulated companies. More recently, there have been other initiatives to try to address these asymmetries of information. These include the use of regulatory 'menus' (where a company can accept a greater challenge for a greater reward), or more targeted ex-ante or ex-post incentives for specific areas of the regulated company's activities. The effectiveness of these techniques, however, depends on how well the regulator has designed the incentive. This in turn requires the regulator to understand what customers value (probably in some detail). It may also require the regulator to make some assumptions about the consistency of performance and responses to these incentives by the regulated company.

Even if the regulator is able to design appropriate incentives for performance improvement, the asymmetry of information between the regulator and the regulated business, and the uncertainty in the timing of future funding needs for the latter will inevitably reduce the long-term effectiveness of these approaches. There is therefore a need to consider the scope for different ways forward to establish more enduring arrangements and reduce the real costs of information asymmetry¹³.

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A 'special factor' is an issue specific to a company that has a disproportionate impact on costs. Property costs in London would be an example.

13

The difficulty of trying to address the asymmetry of information in establishing inputs and outputs is not restricted to economic regulation. For example, the three rounds of Kosygin reforms in the USSR (1965, 1973 and 1979) testify to its difficulty. The Kosygin reforms showed that even GosPlan (notwithstanding its huge resources) could not design ex-ante or ex-post incentives that were consistently effective.

Other factors that require change in our approach to economic regulation of water

Even if the technical approach to setting prices did not have to change, regulation in the water sector will have to take account of several new challenges in the coming years; along with some legacy issues that have not yet been fully addressed. These issues include:



Regulation in the water sector will have to take account of several new challenges in the coming years.

- **Levels of investment:** When regulation was first introduced, the expectation was that high levels of expenditure on improving water quality and environmental performance would be required for around a decade. We now know that significant levels of investment will be required for at least the next 15 years, driven in large part by the on-going improvements in treatment standards.
- **Carbon reduction:** The water industry is a significant user of energy. As such, it has an important role to play in ensuring that we meet our commitments to reduce carbon emissions. This will be a continuing challenge: higher levels of treatment will often (though not always) result in higher emissions.
- **A changing climate:** The water sector will also have to respond to a changing climate, which will impact drainage systems and, potentially, water resources. Maintaining the resilience of services is taken for granted by most customers. Understanding of the impacts of climate change is still developing. It is, therefore, not surprising that the industry has more to do to prepare itself fully. A substantial challenge is likely to lie ahead.
- **Demographic trends:** Population growth, reductions in the size of an average household and a gradual shift in population will all continue to impact the industry. This could increase unit costs (where an asset is bigger than is required because of a reduced population or a change in industrial demand) and could require further investment to increase the size of assets in areas of the country where population is increasing.
- **The maintenance of existing assets:** Assessing the correct level of expenditure on maintenance of assets is very difficult. This is because of the uncertainty that exists in the timing of required maintenance expenditure – with many long life assets – and because of the regulatory focus on establishing a ‘hard budget constraint’. It can also be difficult to demonstrate a material impact on the levels of service experienced by customers of additional spending on maintenance. The approach of the regulator has defaulted to a ‘pay the minimum that is demonstrably required’ approach; investing based on the evidenced short-term performance of the assets, often to the detriment of the long-term performance.
- **A fair price for the service provided:** The ‘pay the minimum that is demonstrably required’ approach shifts the liability for future maintenance onto future generations. Potentially, this means that today’s customer is not paying the full cost of the service that is being provided to them. Given that we have also spread the costs of new assets over time through borrowing, there is a question of inter-generational equity. Current customers benefit both from the legacy asset base (requiring limited maintenance) and this new borrowing. There is a separate question of whether it will be politically acceptable to see the increases in customers’ charges that may come about from this ‘pay the minimum that is demonstrably required’ approach. What would be the response, for example, if Scottish Water were to face an unplanned and urgent need for maintenance expenditure?



Current engagement falls short of what is required.

Further progress is also likely to be increasingly important in ensuring that an effective conduit for customers' and communities' views is established and plays a central role in making the tactical trade-offs (within the policy framework set by the Scottish Government) between the levels of charges and the services that are provided. The Customer Forum, and other stakeholders, may suggest refinements to the draft Objectives of the Scottish Ministers.

Different communities may well make slightly different choices and such differences will likely need to be accommodated where possible and reasonable. Current engagement with, and research into, customers' views and priorities appears to fall short of what will be required if the industry is to meet customers' expectations, maintain their trust, and look beyond compliance.

As an illustration, customers will have views on how, and over what timeframe, the challenges that are set out above should be addressed. There needs to be a greater understanding of the implications of these decisions; for example, the 'pay the minimum that is demonstrably required' approach to asset maintenance will likely place a significant upward pressure on customers' charges in the future.

What role could markets play?¹⁴

As noted earlier, the expectation of the pioneers of economic regulation in the UK was that competition would, through time, remove the need for economic regulation. This expectation has not been met – at least with regard to the water and sewerage industry. In general, however, the unwritten assumption is that the more markets can be relied upon, the more limited the role of the economic regulator has to be. The potential advantage of markets is that market participants can identify new and better ways of providing services to their customers. Water companies have sought to tender the vast majority of their capital expenditure. Many lessons have been learned. Different approaches at different times have worked well. This discussion of the use of markets looks at the options beyond the tendering of, for example, capital expenditure or out-sourcing of IT services.

'For the market' competition

There has been only a limited move towards markets and competition¹⁵. Glas Cymru led the way by tendering its operations activities, asset management and capital delivery. This use of 'for the market competition' was successful in reducing the operating and capital expenditure unit costs of Welsh Water significantly. Levels of service also improved. However, there was no agreement with the regulator that the tendering exercise, in and of itself, was evidence of the company's efficiency. The regulatory response was that the contract outcomes could not be directly compared to the performance of other companies. In essence, the regulatory judgement was that the efficiency of the contracted supplier was, in large part, a function of the ability of the contracting management to describe, document, procure and monitor the level of performance that their customers would expect. Ofwat chose to rely on its benchmarking, rather than the results of a tender, in setting prices.

14

Discussion of the further role that markets could play may be hypothetical in a Scottish context but nonetheless it is instructive to consider the implications in the wider context of the water industry.

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'For the market' competition is more than just tendering the capital expenditure programme. It involves asking a third party to take full responsibility for a function of the water company (for example asset management, planning and operation).

'In the market' competition

A second move towards the use of markets was the opening of the non-household retail market to competition in Scotland in 2008. The Water Services (Scotland) Act 2005 placed a duty on the Water Industry Commission for Scotland to facilitate the entry of new licensed providers to provide retail services to non-household customers. This market is viewed as having worked well over its first nine years¹⁶. There are over 20 retail suppliers operating in the market and non-household customers can choose between different levels of service, payment terms and prices. Retailers have increasingly developed potentially value-adding services (such as advice on water efficiency) to meet the expectations of their customers. A similar non-household retail market opened in England at the start of April 2017¹⁷.

Lessons learned

The non-household retail market appears to be effective for three reasons:

- **It was straightforward to define.** All licensed providers buy wholesale services at the same price and on the same conditions. Their success depends uniquely on how well they meet the needs of their customers and how effectively they can provide the services that they offer.
- **There was no loss of economies of scale or scope, no material externalities or rigidities.** The non-household market does not materially affect household customers. Unit costs of the asset management and operations activities have decreased marginally. The social cross-subsidies (uniform tariff across the country, the link of charges to Council Tax Band and Benefit status) are unaffected. There is no potential for assets to become stranded, which could increase costs for all customers.
- **It allowed the management of the core water and sewerage activities to operate their business in whatever way they choose.** It is unlikely that retail services are a core competence of a water company. As the tendering process used by Glas Cymru shows, there are different ways in which a management could choose to provide a water and sewerage service. They could contract to third parties and manage operations and asset management together or separately. The relative weights of different activities across a water and sewerage company value chain can be quite marked. These weights will substantially depend on the geography of the supply area. The separation of non-household retail does not limit the options available to management.

These three success factors would appear to be a reasonable test of how, and to what extent, markets could be extended in the water industry beyond non-household retail services.

The scope for markets?

It seems quite difficult to design markets where the boundaries of what is open to competition (and what is not) are as easy to define as non-household retail services.

An increased reliance on 'in the market' competition would require that the costs and activities that are open to new entrants can be clearly defined. There will only be market entry if there is a prospect of the entrant earning an appropriate return on capital. To compete in these activities, incumbent companies would also need to have (or to develop) the competences to participate. This may not be straightforward. For example, if a company had always chosen to contract out a particular activity, it would have particular competence in contract definition and management but limited practical knowledge of how to provide the service on the ground. Similarly, the arm of their business that competes in any market would have to do so 'on its merits' and be unable to leverage any legacy relationships or advantages.



It seems quite difficult to design markets where the boundaries of what is open to competition (and what is not) are as easy to define as non-household retail services.

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The Commission has recently made some amendments to the market code and the wholesale terms of trade in order that administration of the market does no detriment to Scottish Water as required by statutory duties.

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There was a retail and upstream market in England and Wales introduced by the Water Industry Act 2003. These arrangements did not appear to work effectively.



More markets in the water sector would likely require more (albeit different) regulation rather than less.

Furthermore, the range of unit costs across the supply area of any water company could make it difficult to avoid incidence effects on some groups of customers on any activities that could be opened to competition. Under competition law, the owner of an essential facility has to provide access at a fair and non-discriminatory price. It is not clear how such access could be provided to any appropriate market entrant with regional differences in costs not being reflected in prices to customers¹⁸.

Perhaps most troublesome is the final challenge: is it possible to define an area where markets could be relied upon that allows management the flexibility to provide services to customers in the most efficient and effective way and to meet whatever expectations their customers may have?

It is perhaps, therefore, not surprising that 'in the market' competition has played only a limited role. It is difficult to imagine how that role can be increased materially. Society's expectation that the water and sewerage service should be universal (not dissimilar to daily letter delivery across the whole of the UK) actually leads to a slightly surprising conclusion. More markets in the water sector would likely require more (albeit different) regulation rather than less.

In the absence of targeted regulation, there would likely be incidence effects between groups of customers, unforeseen externalities, and market rigidities (such as the stranding of assets).¹⁹ It is unlikely that any material benefits to customers through additional innovation would outweigh these potential disadvantages. There would, for example, likely be a substantial increase in the cost of capital (reflecting increased risk but also because the industry would almost certainly have less capacity to borrow).

Are markets consistent with future proofing?

Perhaps the most problematic issue with a reliance on markets relates to time inconsistency. Markets typically operate in the here and now²⁰. Supply and demand are matched in the short term.

Markets can operate quite well when assets have extended lives (providing there are substantial barriers to entry). There are relatively effective markets in asset intensive industries such as chemicals, paper and fuel products. However, these industries are characterised by significant price volatility, which directly impacts consumers. Competing companies also experience significant profit volatility. Examples of such industries would include bulk chemicals, paper and oil products.

The positive impact of any market arrangements may be reduced if the geographic scope of a market is limited (due to natural or financial boundaries). Markets in aggregates, for example, tend to be local and can still experience both profit and price volatility.

The water industry has extended asset lives, is very regional and, because it is a universal service that we all need, customers (and politicians) would be highly unlikely to accept price volatility. Similarly, stakeholders would be unlikely to be comfortable with profit volatility when they understood that it could make the service provider slow, or even reluctant, to respond quickly to an environmental or service level issue. This would, all else equal, make the attracting of capital to competing water companies particularly problematic.

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Our work with Scottish Water has revealed that some rural areas are up to sixty times more expensive in unit cost terms than a large urban area. The implications of unwinding this cross-subsidy would be very significant.

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The term stranded assets in this context relates to installed plant and equipment whose original purpose has been impacted by unforeseen changes in the usage.

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Consider the economist's view on 'sunk costs' - which is that they should not influence future behaviour.

Timely replacement of existing assets (which is essential if service levels are to be maintained and customers' expectations met) could also be problematic. Would asset replacement happen in a timely way if the service provider has recently experienced losses? Even if there were a regulated element, how robust would the provisioning for future investment be, if there were no restrictions placed on this capital and if it was not monitored effectively? New owners could seek to take advantage of perceived surplus cash. The example of defined benefit pension plans applies²¹.



The most successful participants in markets are those that are most focused on the customer.

There are, however, lessons that can be taken from successful markets. The most successful participants in markets are those that are most focused on the customer. They win and retain customer loyalty. Their customers believe that they offer excellent value for money. They are typically also seen to treat their staff and supply chain fairly. They depend on their reputation for their current and future success. They are, in short, good corporate citizens.

An alternative approach – Collaboration: “Seek Trust but Expect Verification”

Traditional economic regulation has generally resulted in a 'parent – child' relationship. The regulated company works out how to live within the costs allowed for by the regulator. It also has to decide how it will deliver the required levels of service. The primacy of the regulator in this relationship explains why regulated companies will allow themselves some leeway in the costs and potential levels of service that they offer to the regulator and their customers. This relationship is demonstrably inconsistent with the behaviour and value for money offered by companies that succeed in effective markets.

Our approach at the last price review was to seek to empower Scottish Water and to challenge them to reach a reasonable agreement with their customers. We sought to encourage, cajole and challenge Scottish Water to think continually about its reputation. We wanted to make Scottish Water directly responsible to its customers and other stakeholders. It should not want, be able, or allowed, to hide behind its regulators or Government. The regulated company should be able to justify and explain its prices (including the level of profit that it makes) and its levels of service to its customers. In short its success, just like that of a company in a competitive market, should depend on it maintaining and strengthening its reputation with its customers, the communities it serves and its stakeholders.

We were very encouraged to learn of the work of Christopher Hodges, Professor of Justice Systems at the University of Oxford. His work on ethical business regulation appears to be closely aligned with the practical steps that we are taking. For example, we agree strongly with his conclusions that a constructive relationship – backed by strong incentives to 'do the right thing' – will maximise performance, compliance and innovation.

The Scottish Government has adopted the work of Professor Hodges as the basis for their thinking of how best to use their new consumer powers and, more generally, how regulation should work in the interests of customers.

²¹

Acquiring companies regularly took advantage of over-funded pension schemes before regulation was strengthened.

There appear to be several steps required to reduce the potential for information asymmetry, ensure there is no regulatory capture and empower customers and communities to the maximum extent possible. These steps seem to us to include:

Engagement

- Greater trust and openness between regulators and the regulated, which will act as a catalyst for a far more productive relationship and the ability to take forward joint solutions to address the challenges ahead;
- Direct engagement between the regulated company and its customers to agree a detailed business plan that will meet the needs of the full range of its customers;

Managing risk

- An opportunity to agree how uncertainty and risk should be handled: helping drive improved performance and greater innovation;
- An opportunity to provide revenue certainty beyond a particular regulatory control period if this could reduce costs or improve levels of service;

Monitoring and reporting

- Fully transparent reporting of performance - with appropriate evidence - and progress towards meeting agreed service levels and other targets by the company - with further detail being available to those who wish it;
- A mechanism to monitor financial performance and ensure that returns are fair and not excessive but also that a company is insulated from unexpected costs;

Governance

- An expectation that a regulated company will identify the extent of out-performance and discuss how to share the benefits with its owner and other stakeholders (including the scope for immediate improvements or by putting the money away for the proverbial rainy day);
- Scottish Water to take full responsibility for its capital expenditure and be directly accountable to its customers and to the Quality Regulators. It should be able to evidence why it has taken the steps that it has; and
- A strong regulatory body that is able to comment authoritatively on performance. The regulator would produce a high quality and accessible monitoring report - with further detail being available to those who wish it. This would include an expectation that negative comments from the regulator should have a material impact on the management of the regulated company and its reputation.

For the Strategic Review of Charges 2021-27, the Water Industry Commission for Scotland wants to build upon what has already been achieved and to place further responsibility on Scottish Water. We want to see Scottish Water taking further ownership of, and sole responsibility for, its relationship with its customers. It should act, and be seen to act, in the best interests of both today's and future customers. This Review will be a further step towards a more directly accountable Scottish Water. We want Scottish Water to build enduring trust with its customers by setting out its evidence fully. We recognise that regulators and other stakeholders will also likely have to give Scottish Water the space to be open when things do not work out as planned. Scottish Water should understand that trust is much more easily lost than it is gained. It should also understand that, if there is a shortfall in its evidence, stakeholders will likely seek verification (with probable consequences for the level of trust).



We must take steps to reduce the potential for information asymmetry.



The Commission plans to put the onus on Scottish Water to plan its funding for identified projects that extend beyond the fixed regulatory control period.

Embedding Trust

There is an increasing recognition of the significant benefits associated with building a relationship based on fairness, trust and openness between a regulator and a regulated company. In Chapter 3 of this methodology we explore the benefits of embedding trust in the regulatory framework and highlight how this will be essential to meeting the challenges ahead for the industry.

Direct engagement

The regulated company should maintain an active dialogue with its customers and stakeholders. The Commission has agreed with the Consumer Futures Unit of Citizens Advice Scotland and Scottish Water to establish a Customer Forum. This builds upon the success of a similar group at the last Strategic Review of Charges, ensuring that the level of customer and community ownership is further enhanced. The Forum is a small group of the household and licensed provider customers of Scottish Water.

The Forum is charged with reaching an agreement with Scottish Water on charges and service level priorities. Its agreement should reflect fully the decisions taken by the Commission on the ranges for the key inputs to the Strategic Review of Charges. We outline our expectations in this regard later in our methodology²². We want the new Customer Forum to build on the excellent work of its predecessor²³ and expand on its predecessor's customer engagement and outreach. The Forum is a conduit for the views of customers and communities.

Managing uncertainty

The Commission understands and accepts that innovative approaches are essential in driving long term customer benefits but require an acceptance that they will not always be effective in delivering the desired outcomes for customers and our environment. Scottish Water should not face a financial penalty if it is trying – through testing innovative solutions - to deliver the best outcomes for customers or our environment. In Chapter 5 we review the barriers to innovation and set out our approach to overcome these. In our view, innovation will likely require close collaboration with the drinking water quality and environmental regulators.

Revenue certainty

The Commission plans to put the onus on Scottish Water to plan its funding for identified projects that extend beyond the fixed regulatory control period. We would expect Scottish Water to explain, through its investment appraisal, to its customers and its stakeholders how a complex project could take many years to deliver (such as the Glasgow integrated drainage scheme). Alternatively, Scottish Water may want to explain how it could improve performance if the payback on the initial expenditure exceeded the length of the current regulatory control period. In short, the Commission wishes to avoid placing artificial funding constraints on Scottish Water and wants them to be able to deliver the best possible outcomes for customers.

Transparent reporting of performance

Scottish Water should report regularly and transparently on its financial, operating and level of service performance. The Commission expects this reporting to be clear, detailed and complete. Scottish Water should set out its evidence. It should also be consistent between reporting periods. The Commission will comment on the evidence provided by Scottish Water and any other external evidence that becomes available. It will publish both a summary analysis of performance and make more detailed comments available to those who are interested.

²²
Chapter 4.

²³
The success of the Customer Forum has been recognised in several reviews. Three examples are particularly worthy of note: it agreed a higher level of capital efficiency with Scottish Water than the economic regulator could have required using available benchmarking techniques; it agreed a price cap in nominal terms for the last year of the previous regulatory control period and the first three years of the current period; and it negotiated the introduction of specific new measures of comparing performance beyond the confines of the utility sector.



Scottish Water could, for example, agree the format of appraisals and publish them.

The financial tramlines

The financial tramlines established for the current regulatory period offer protection to both customers and Scottish Water. They ensure that Scottish Water is financially sustainable and protected from unexpected operational shocks. Customers are protected because if Scottish Water is able to deliver services more cost effectively, the savings are redirected towards additional customer benefits. The Scottish Government recognises the contribution of the tramlines to the sustainable funding of Scottish Water. We believe there is scope to develop further the financial tramlines approach to ensure appropriate allocation of costs between current and future customers. Chapter 7 outlines our thinking in this area.

Benefit sharing

In corporate governance terms, one of the most important decisions for a Board is to declare a dividend at the end of a financial year. It sends an important signal as to how the Board believes a company has performed and gives an indication of how it sees the future.

Although Scottish Water is a publicly-owned corporation, we believe there are important lessons that we could learn. In our view, customers' and communities' trust in Scottish Water would be enhanced if they understood that the Scottish Water Board reviews performance based on the tramlines and decides in consultation with its owner²⁴ and its other stakeholders how out-performance during the previous financial year should be managed. There may be an opportunity to share it with customers in the short term or to provide for increased resilience or the longer-term maintenance of Scottish Water's assets. Similarly, if the Board were to produce an annual 'performance statement', the trust of customers, communities and stakeholders would likely be increased.

Taking ownership of identifying the scope for improvement in the capital programme

We plan to use a different approach at this price review. We will ask Scottish Water to propose an allowance for capital expenditure in both its strategic projections and in its draft business plan. The Commission's advice to the Customer Forum will primarily focus on the deliverability of large capital expenditure programmes and the implications for prices of different sizes of capital programme. This would include the need to understand better, the long term service level maintenance requirements and the trade-offs (in terms of cost and risk) between building new assets and maintaining existing assets. Scottish Water should work with its stakeholders to seek their trust that it is doing the right thing. It could, for example, agree the format of appraisals and publish them.

Strong regulatory body

The Water Industry Commission for Scotland will use the information provided by Scottish Water to analyse its performance and progress. It will also use information from other water companies in its analysis. The Commission hopes that Scottish Water continues its recent excellent performance and that it will be able to recognise the results. It will, of course, call out weaknesses should this be appropriate.

These steps are designed to make it easier for Scottish Water to take advantage of opportunities to innovate and to identify the best and most effective ways to address the needs of their customers.

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The Scottish Government will also likely be interested in how any such out-performance is deployed. It could have implications for Government policy more generally.

So what needs to change under this “Collaboration: Seek Trust but Expect Verification” approach?

The approach outlined in this chapter requires all the key stakeholders – owner, company and regulator – to change.



Customers will react negatively if they come to understand that problems have been stored up for the future.

Owner

Different types of ownership will obviously have different types of objective. For this approach to be effective and returns to be reasonable and sustainable, an owner needs to think long term and recognise that maintaining the legitimacy of water charges in the eyes of customers is the critical challenge. Customers – the ultimate guarantor of financial sustainability – will react negatively if they come to understand that problems have been stored up for the future that could have been addressed more pro-actively and more cost effectively.

Regulated Company

A regulated company needs to demonstrate how and why it is acting in the best interests of its customers – both now and into the future. It has to recognise that its approach will be subject to detailed scrutiny and comment and that its customers will, in future, have ever higher expectations.

Economic Regulator

The skills required in the economic regulator would be quite different. The focus is less on econometric modelling and the design of incentives and more on scrutiny of analysis, forensic questioning and rigorous performance monitoring. As such, the regulator seeks to reduce asymmetries of information and acts as an enabler of effective engagement. Communicating views to the Customer Forum requires some rather technical analysis to be communicated in straightforward and relevant terms. It is perhaps worthwhile noting that the costs have reduced substantially since this less immediately adversarial approach was adopted²⁵.

Customers

Customers should of course expect and demand an improved level of service today. Equally important, however, is that customers feel reassured that issues (whether in terms of charging or levels of service) are not being stored up for the future.

Conclusion

The economic regulation of the water industry in Great Britain has been very successful. Costs are down, levels of service are up and environmental and water quality compliance is at record levels. There is, however, no room for complacency. As an economic regulator, the Water Industry Commission for Scotland needs to continue to develop the regulatory framework in a way that allows (and requires) Scottish Water to meet the needs of its customers in the most effective way possible.

As we look forward, there are a number of unresolved issues (such as the long term provision for asset replacement) and new challenges (such as demographic change and the changing climate). The regulatory framework must allow Scottish Water to tackle these issues as effectively as possible, and to look beyond compliance.

Whatever the future holds, it will be increasingly important that Scottish Water is, and is seen to be, accountable to its customers. This is at the heart of our regulatory approach for the next Strategic Review of Charges.

²⁵

The Commission's regulation costs have decreased by nearly 55% in real terms since 2006/07 from £4.497 million to £2.032 million in 2016/17 (2006/07 has been revalorised using RPI to 2015/16 prices).

3

Embedding trust

The level of collaboration and trust among stakeholders is a key determinant in the quality of both the information shared and decisions taken in an industry. This chapter explores how stakeholders in the Scottish water industry have begun to build greater trust by working together to meet challenges. In our view, this trust should be further embedded in each organisation to ensure that we can collaborate effectively to tackle the challenges of the future.

Introduction

The journey of the Scottish water industry has progressed through multiple distinct phases since economic regulation was established in 1999. Each phase was geared towards improving the industry's efficiency and, at the same time, investing to meet international standards for the quality of service provided.

Since the merger of the three regional water authorities in 2002, Scottish Water has rapidly improved its performance. Service levels are now amongst the best in the United Kingdom and average charges are the second lowest. During this period, Scottish Water has increasingly worked with its water quality and environmental regulators to make progress in improving our environment and the quality of water that we drink. It has worked constructively with Consumer Focus Scotland. It has also collaborated with the Commission to implement retail competition for non-household customers. More recently, Scottish Water worked with customers to agree its Business Plan.

These steps have each brought benefits to customers. For example, Scottish Water offered the Customer Forum a level of efficiency over and beyond that which the regulator could have justified, using the standard benchmarking techniques. Collectively, Scottish Water has taken a great leap forward in owning its decisions and building trust with its regulators and its customers.

As discussed in Chapter 2, embedding trust among stakeholders will be a key enabler to improving the quality of decisions taken in the Scottish water industry and driving benefits for customers. It is a principal foundation of the Ethical Business Regulation (EBR) concept, developed by Professor Chris Hodges of Oxford University.

Stakeholders in the Scottish industry have naturally tended to adopt elements of the EBR principles when faced with problems. There is little question that the Board and Management of Scottish Water have turned to collaboration when responding to the challenges of their economic, water quality and environmental regulators – bilaterally and collectively.

We believe there is tremendous scope for stakeholders to embed these principles, not just at times of challenge, into the on-going regulatory framework. This will help build upon the work that is currently underway in the industry but will also contribute to identifying the limitations in the current regulatory framework and explore ways in which it can be improved. Building trust among customers and stakeholders will be essential if the industry is to meet the challenges that lie ahead.

Our approach at the last Strategic Review of Charges

The key focus at the last Strategic Review of Charges (SRC15) was on empowering Scottish Water to take full ownership of its decisions – both in its business planning and in the delivery of that plan for customers. We wanted Scottish Water to be fully accountable to its customers, and to be setting the strategic direction of the company based on its understanding of customers' priorities, along with the requirements set by Ministers and by Statute.

The Commission worked closely with Scottish Water and the Scottish Consumer Council to create a Customer Forum. The resulting Co-operation Agreement reflected a shared desire among stakeholders to introduce a far more collaborative and trusting approach to customer engagement to the price review process.

As part of this approach, we asked Scottish Water to publish a long-term (25 year) strategy. We were particularly keen that its 6 year business plan should be fully consistent with its longer term strategic projections. We offered Scottish Water the opportunity to identify projects whose payback stretched beyond the regulatory control period. These projects were to be ring-fenced. The strategic projections included an indication of the financial resources that would be required over the long term and the route-map to achieving the expected drinking water quality, environmental and customer service performance standards. Scottish Water had to work closely with Scottish Government, SEPA, DWQR and the consumer representatives to develop these strategic projections and reach a common vision for the industry in Scotland.

What worked well?

The introduction of the Customer Forum has proved to be a major driver in building trust between Scottish Water and its customers. The Forum has ensured that there is an increased level of customer engagement throughout the Strategic Review process. Moreover, Scottish Water appears to have improved its understanding of how best to discuss its performance with its customers. The success of the engagement process reflected the high levels of trust and openness between the Customer Forum and Scottish Water.

The development of Scottish Water's 25 year strategic projections document has provided customers and stakeholders with far greater transparency of the direction of travel for the industry – and hence assurance that Scottish Water is focused on the long-term sustainability of its services. The strategic projections facilitate an improved dialogue with customers on key strategic decisions: such as the long-term proposals to create greater interconnection between water supply zones and to ensure the long-term integrity of assets. We believe these strategic projections are now a critical element of the price setting process.

There has also been a welcome increase in the level of collaborative working between stakeholders to identify innovative and lowest whole-life cost solutions. SEPA and DWQR have worked more closely with Scottish Water on studying and identifying better approaches to meeting the required outcomes. A notable example is the recent joint work between Scottish Water, SEPA and other stakeholders to develop cost-effective and sustainable solutions for Glasgow. This collaborative approach could help bring the River Clyde in Glasgow into compliance with European standards at a fraction of the initially estimated costs.

Collaboration is also assisted by the close joint working between stakeholders in a number of bilateral and multi-lateral fora. In particular, the Outputs Monitoring Group, chaired by the Scottish Government, has played a very important role in building trust among stakeholders.



The introduction of the Customer Forum has proved to be a major driver in building trust between Scottish Water and its customers.

What should we do better?

One of the barriers identified by Professor Hodges to a more constructive relationship between the regulator and regulated company, and between a regulated company and its customers, is the complexity of an industry. In this context, the Commission has discussed:

- The assets tend to have long and not always predictable lives;
- It is difficult to be confident in any whole life cost analysis because asset lives can only be estimated;
- Scottish Water does not have a full picture of the performance and condition of its underground assets;
- Investments in the water sector often bring indirect benefits (and costs). These externalities are difficult to value objectively; and
- The list of objectives placed by government on regulators has become longer over time.

There is more that we could do to improve understanding of capital maintenance, system risk and resilience. Customers have a right to expect that assets are being maintained appropriately and that problems are not being stored up for the future. The water industry will need to improve the information that it has on asset performance and condition and be able to demonstrate to its customers and other stakeholders that it is managing its assets in the most efficient manner possible. This will require a high degree of trust and collaboration between stakeholders. The EBR principles will help foster this collaboration.

Information becomes increasingly important as we seek to deliver higher environmental and water quality standards. As discussed in Chapter 2, there is more that we can do to address potential information asymmetries. We will be particularly supportive of Scottish Water's efforts in this area.

In working with Scottish Water to define the investment requirements to meet the company's statutory obligations, SEPA and DWQR have traditionally tended to adopt the role of the 'policeman', focusing on compliance with statutory obligations. Recently, they have worked more closely with Scottish Water to determine the most appropriate approach to delivering the required outputs. In our view, such joint working is in the interests of customers and society more generally. Scottish Water has to seek the trust of the Quality Regulators but also expect them to seek verification should they feel the need to do so.

What do we plan for the Strategic Review of Charges 2021-27?

Developing trust and confidence between the company, customers and stakeholders lies at the heart of EBR. Professor Hodges summarised the elements of EBR in the following terms²⁶.

- The regulatory system will be most effective in affecting the behaviour of individuals when it supports ethical and fair behaviour;
- Businesses should continually demonstrate evidence of their commitment to fair and ethical behaviour that will support the trust of regulators and enforcers, as well as of all levels of management and employees, customers, suppliers, investors and stakeholders;
- A blame culture will inhibit learning and an ethical culture, so businesses and regulators should support an open collaborative culture;
- Regulatory systems need to be based on collaboration if they are to support an ethical regime, as well as maximising performance, compliance and innovation; and
- Where there is unethical behaviour, people expect a proportionate response. This is consistent with strong sanctions for intentional wrongdoing.



Customers have a right to expect that assets are being maintained appropriately and that problems are not being stored up for the future.

26

Summarised in Ethical Business Regulation: Understanding the Evidence Christopher Hodges Professor of Justice Systems, and Fellow of Wolfson College, University of Oxford, BIS Better Regulation Delivery Office, (March 2016)

The essence of EBR is to 'do the right thing' and speak up in sharing all relevant information in open relationships, so as continuously to learn and improve. It is about relationships inside and outside a company. The crucial aspects of EBR are the degree of collaboration, openness and transparency on which relationships and transactions are based.

It is important to stress that EBR is not 'soft touch' regulation, nor does it lead to regulatory capture. It is, if appropriately implemented, quite the reverse. As noted in Professor Hodges's principles above, the requirement for strong penalties for misbehaviour are fundamental and are clearly acknowledged and accepted. The evidence of a shortfall in behaviours will be obvious. In moving to a more innovative and customer centric organisation, and in building the required levels of trust with stakeholders, Scottish Water will need to up its game. The Commission will watch closely and comment appropriately.

Both the UK Government and the Scottish Government have indicated their support for taking forward EBR approaches. The Scottish Government is keen to understand how these approaches are being used and how they could be further applied in the water sector. They also want to explore the scope for extending EBR to other regulated sectors in Scotland. We have therefore been working with Scottish Government, Scottish Water and industry stakeholders to establish an understanding of the necessary conditions for EBR. The output from a roundtable event²⁷ of industry stakeholders identified these pre-requisites:

- Public policy and customer outcomes that are well articulated, measurable and shared;
- Roles of the organisations involved that are clear with well-defined responsibilities and relationships;
- Shared understanding of the risks and who bears them;
- Policies and arrangements that are sustainable beyond personalities and goodwill;
- Demonstrated openness and honesty about information and evidence; and
- Acknowledged importance of robust challenge within the collaborative approach.

The first three of these are perhaps unsurprising and would form part of any programme for more effective policy and regulation²⁸. The policy role of Government must be clearly separated from the responsibilities of the regulator. Fortunately, the governance framework in place for the water industry in Scotland supports this separation of role and underpins our ability to work with Government and other stakeholders to realise the full potential of EBR in the Scottish water sector.

The last three pre-requisites underpin the effective implementation of EBR. They focus on building enduring trust while respecting the different roles of organisations within the regulatory framework. As part of the output from the round-table, we have assessed the extent to which we currently meet these conditions. This assessment will allow us to identify the additional steps that we will need to take. Table 1 indicates this high level assessment.



Both the UK Government and the Scottish Government have indicated their support for taking forward EBR approaches.

²⁷

"Briefing paper for roundtable on 17th January 2017" – available on our website at <http://www.watercommission.co.uk/UserFiles/Documents/Roundtable%20event%20output.pdf>

²⁸

The regular budget framework has the potential to impact Scottish Water unexpectedly. This could impact Scottish Water's operations.

Table 1: Assessment of the regulatory framework for water in Scotland

Conditions	Assessment of where we are
Public policy and customer-oriented outcomes	Well established customer-oriented outcomes process in the water sector. The Scottish Government is still developing its approach to introducing EBR and, as such, there is more to do to establish EBR as fundamental to consumer policy in Scotland.
Role clarity	Well developed. The Water Services (Scotland) Act 2005 carefully designed the governance framework of the water industry in Scotland. Practical experience subsequently has built upon that clarity.
Shared understanding of risk	Further development needed. One particular area where an improved understanding of risk is crucial is in respect to approaches to long term service maintenance expenditure.
Sustainable beyond personalities and goodwill	We believe that progress has been made (the introduction of the Customer Forum, the Outputs Monitoring Group, the Quality and Standards Process) but there will always be more to be done. It would be fair to say that the sustainability of the framework has not been fully tested by adversity.
Openness about information	Improving as collaboration develops – there is a clearly observable reduction in any tendency towards a blame culture. Again, progress in this direction has not been fully tested by adversity.
Challenge	All stakeholders acknowledge that challenge and the capacity to take action is an essential element of a regulatory framework that is underpinned by EBR. There is still more to do.



All the evidence to be shared, all of the time.

We conclude that there is further scope to embed EBR in the regulatory framework for the Scottish water industry: not least in encouraging and seeking more open dialogue. While some considerable progress has been made, it will not be straightforward to change the traditional culture of regulatory ‘gaming’ whereby each party seeks to gain advantage over the other by focusing principally on the evidence that supports their case. We need all the evidence to be shared, all of the time.

We will continue to work with Scottish Water, Scottish Government and other stakeholders to develop further our approach to embedding EBR principles in SRC21. We believe EBR approaches will provide significant benefits for customers in the following areas:

- Extending the customer engagement model;
- Empowering Scottish Water such that the onus is on it to demonstrate that it is efficient, effective and innovative; and
- Developing a joint approach to Capital Maintenance.

We will return to each of these three issues later in the methodology. Our approach is perhaps best summarised by the principle ‘Seek Trust but Expect Verification’. We are focusing on providing Scottish Water with the opportunity to demonstrate to customers and stakeholders that they are working collaboratively with others. They should do this in a way that engenders trust and provides assurance, through providing high levels of transparency of performance, fully supported by evidence.

The use of Natural Capital can help illustrate the value and trade-offs inherent in economic externalities. We believe that the stakeholders in the Scottish water industry could explore whether and how Natural Capital may have a role.

How will this approach benefit customers?

Customers should pay no more than is necessary. Cost effective solutions will be key to meeting the challenges that the industry faces going forward. There will need to be more understanding and discussion of costs, risks and opportunities. Stakeholders will have to work collaboratively. We will, as explained in Chapter 2, have to avoid unnecessary asymmetries of information.

Adopting EBR, and consequently recognising that verification of the evidence provided in support of a particular approach is fundamental, should ensure that the long-term sustainability of the industry is maintained in the most cost effective way. Scottish Water will own its decisions. It will have the freedom to run its business. The quid pro quo, however, is that it will not be able 'to hide behind its regulators'. In our view, customers' charges will be lower than they otherwise would have been. It seems likely that Scottish Water's ownership of its decisions and the trust that it is building with customers will help ensure that problems are not stored up for future generations.

The changes in the regulatory approach that we are planning are underpinned by the greater transparency that all stakeholders will have the right to expect from Scottish Water.

What will success look like?

The successful implementation of EBR will increase collaboration and trust among all stakeholders. The result should be:

- **Empowerment:** Scottish Water will own its decisions;
- **Accountability:** Scottish Water will evidence why its performance is good. It will openly admit where it may fall short;
- **Collaboration:** Scottish Water and its regulators will work collaboratively and constructively to identify and implement lowest whole-life cost solutions;
- **Transparency:** There will be a greater understanding of what has been achieved and what still needs to be done. All stakeholders should, if they so choose, be able to understand why decisions were taken; and
- **Demonstrating progress:** Scottish Water should be able, for example, to evidence its contribution to reducing carbon, a circular economy and the Scottish Government's ambition to be a Hydro-Nation.

In short, there will have been further progress in changing the culture of the water industry in Scotland. This is an ambitious agenda. It will take time to be fully effective. However, an approach of "Seek Trust but Expect Verification" should ensure that potential benefits for customers are realised, even in the next regulatory control period.

Conclusion

The water industry in Scotland has successfully taken steps to develop a culture of trust, openness and collaboration among stakeholders. There is, however, no room for complacency. There is more that all stakeholders can do to facilitate EBR. The Commission will seek to empower Scottish Water. Scottish Water should rise to the challenge, as it has done consistently since it was established in 2002, and win the trust of its customers. It should be able to evidence why the choices it has made were as good as they could have been. In our view, EBR can help the step function change in performance that will be required if we are to address fully and effectively the challenges facing the industry in the future. This approach will ensure that customers' bills are no higher than they need to be and that levels of service will continue to improve.



Customers should pay no more than is necessary.

4

Expanding engagement

This chapter sets out the steps we are taking to enhance the level of customer engagement in the Strategic Review of Charges. Our approach will build on the excellent work of the Customer Forum at the last price review. In particular, we have allowed more time for discussions between all the stakeholders in this Strategic Review of Charges. We have also allocated more resources to the Customer Forum in order that it can reach out to communities and wider stakeholder groups.

Introduction

The Water Industry Commission for Scotland has been at the forefront of establishing customer-centric regulation - where the primary focus for a company is on its customers rather than its regulators - based on the regulatory approaches proposed by Professor Stephen Littlechild. Professor Littlechild was the designer of price cap regulation and advised the UK Government on privatisation and regulation. He subsequently was appointed as the Director General of the Office for Electricity Regulation (OFFER). His recommendations on customer engagement were developed following extensive study of regulatory practices across a range of sectors and countries.

We see customer engagement as an essential element of the economic regulatory process. Engagement can, however, only be truly effective if customers are empowered to take meaningful decisions. Customers need to know what inputs to and outputs of a Strategic Review of Charges are realistic and sustainable (for example, a water company needs to earn a high gross profit margin if it is to be able to invest consistently for the long term). As such, empowering customers requires the Commission to take steps to inform them of what it considers possible (and consistent with the statutory framework). The Commission monitors performance carefully and acts to ensure that the customers' interest is protected.

The Scottish Government has welcomed this consumer-centric approach and sees it as essential to good regulatory practice across all sectors. CFU sees this approach as fully consistent with its high level consumer principles²⁹.

This chapter seeks to build on the experience gained at the last Strategic Review of Charges. We consider that the Customer Forum model provides a practical example of the application of the principles of 'Ethical Based Regulation' (EBR), which we discussed in the previous chapter.

²⁹

The Consumer Futures Unit (CFU) within Citizens Advice Scotland (CAS). Its principles are set out at <http://www.cas.org.uk/about-us/social-policy/consumer-futures>

Our approach at the last Strategic Review of Charges

In common with other regulators, we used to publish consultations to seek the views of other stakeholders. This normally included proposing a course of action or offering a choice, and inviting stakeholders to respond. However, this approach had two particular limitations:

- It is difficult to access the views of those who are broadly content with the proposals (or who do not think the proposals are relevant to them); and
- Given that those who respond often have a strong view for or against the proposals, or have a specialist interest in the matter, it is challenging to know how much weight to give to these responses.



At the Strategic Review of Charges 2015-21, we worked with Scottish Water and the Scottish Consumer Council to establish a Customer Forum.

At the Strategic Review of Charges 2015-21, we worked with Scottish Water and the Scottish Consumer Council³⁰ to establish a Customer Forum. This Forum was to act as a conduit for customers' views and the Commission asked it to seek to reach an agreement with Scottish Water – within parameters determined by the Commission – on the key outcomes of the process. Our aim was to encourage Scottish Water to focus on its customers rather than on its regulator. This approach was innovative. It built upon the work of the CAA in regulating airports and the air traffic control service. Scottish Water rose to the challenge.

The 2015-21 Customer Forum had nine members, including its Chairman, Peter Peacock CBE. The Scottish Consumer Council nominated five of the eight ordinary members and the two largest retailers operating in the non-household Scottish retail market each appointed a member. The Scottish Council for Development and Industry (SCDI) appointed the remaining member.

The Commission issued a series of clear decisions throughout the price review process. These decisions set out ranges for key inputs to the price review such as operating expenditure, capital expenditure, efficiency and inflation. The Commission set out its first view on the appropriate ranges for these key inputs in advance of Scottish Water's Strategic Projections. The Commission reviewed and refined its view in the light of the views of the Customer Forum and of Scottish Water's Strategic Projections and again in response to Scottish Water's draft Business Plan. As such, the process allowed for more effective and informed consultation.

What worked well?

The Customer Forum approach allowed for a number of improvements to the regulatory process including:

- Establishing a more effective conduit for customers' views;
- Scottish Water was more focused on its customers than on its regulator;
- The price review process cost less to implement; and
- was more streamlined, which meant that it reached an earlier conclusion. This earlier conclusion to the price review process meant that Scottish Water had more time to implement its Business Plan.

Key to this success was the clear signal from the Commission that if the Customer Forum was able to reach agreement with Scottish Water, within the ranges determined by the Commission, the Commission would be minded to accept this agreement as its draft determination.

³⁰

The Scottish Consumer Council has been disbanded. Its water activities were transferred to the Consumer Futures Unit of the Citizens' Advice Bureaux in Scotland.

The approach achieved better outcomes for customers than would have been possible under previous price reviews. For example, Scottish Water set itself a capital expenditure efficiency challenge that was larger than the Commission could have justified if it had set prices using a more traditional approach.

There were also other benefits that this negotiation achieved:

- The Customer Forum was able to agree additional improvements in customer service; and
- There was an innovative agreement between Scottish Water and the Customer Forum to fix nominal increases in charges for the first three years of the current regulatory period and reduce the increase for the last year of the previous regulatory control period. This brought stability and transparency to charges.



It is important to consider the views of local communities both on prices and levels of service.

What should we do better?

The Customer Forum approach adopted in the Strategic Review of Charges 2015-21 has been subject to a number of comprehensive reviews, including by members of the Forum³¹, by Professor Stephen Littlechild³² and by Professor Martin Lodge³³. We agree with their key observations.

There is clear scope to improve:

- The timing and profile of, and level of awareness about, the Commission's decisions;
- The Customer Forum's interaction with the Commission and other stakeholders;
- The outreach of the Customer Forum; and
- Scottish Water could take even greater accountability for its performance.

Looking at each of these in turn.

The timing and profile of, and level of awareness about, the Commission's decisions

The Commission has the statutory duty to set charges. It is therefore important to be clear to stakeholders that the Commission takes an important decision each time it sets ranges for the key inputs to the price review or, indeed, comments (either positively or negatively) on an input to the process from Scottish Water. It is also important to ensure that the Strategic Review process includes sufficient opportunities for discussions between the Commission and Scottish Water to inform the setting of these ranges for the most material inputs.

The Customer Forum's interaction with the Commission and other stakeholders

The reviews noted that there was scope for greater interaction between the members of the Commission and the Customer Forum and also between the Customer Forum and other stakeholders. Along with increasing the legitimacy of the process, this would be consistent with embedding trust with stakeholders and opening up the possibility for greater joint working.

The outreach of the Customer Forum

Potentially, the Customer Forum could have done more to seek out the views of local communities.

It is important to consider the views of local communities both on prices and levels of service. Similarly, bodies such as the youth parliament could provide input on aspects such as intergenerational equity. Such a variety of engagement with different communities (in their broadest sense) would ensure that the Customer Forum will be better placed to identify the best outcome for customers as a whole - within the ranges specified by the Commission.

³¹ Lessons learned from customer involvement in the 2015-2021 Strategic Review of Charges' available at www.watercommission.co.uk/UserFiles/Documents/Legacy_report.pdf

³² See www.rpieurope.org/Publications/Studies_New_Series/Studies_NS_4_2_Littlechild_July_2014.pdf

³³ See www.lse.ac.uk/accounting/CARR/pdf/DPs/CARR-DP81-Eva-Heims-and-Martin-Lodge.pdf



A successful negotiation requires both parties to believe in the good faith of the counterparty.

Scottish Water's accountability for its performance

As we have already explained, Scottish Water responded well to the Customer Forum. In our view, we should all learn from the success of the negotiation process. A successful negotiation requires both parties to believe in the good faith of the counterparty.

Notwithstanding the success of the first Customer Forum, we believe Scottish Water could still do more to evidence that it is taking all reasonable steps to make itself as efficient and customer focused as possible. The better its evidence, the more likely it is that it will win the support of its customers. In the same vein, the Customer Forum is more likely to be successful in achieving its priorities if it is able to evidence to Scottish Water why these priorities are both important and urgent.

What do we plan for the Strategic Review of Charges 2021-27?

Our plan focuses on the following five areas:

- Greater interaction between the Customer Forum, Commission members and other stakeholders;
- The role and remit of the Customer Forum;
- Ensuring the Forum is sufficiently resourced;
- Encouraging Scottish Water and the Customer Forum to be accountable to each other and provide the best evidence available for their views (Seek Trust but Expect Verification); and
- The timeline for the engagement process.

The interaction with the members of the Commission and other stakeholders

The timeline for the Strategic Review of Charges 2021-27, set out in Appendix 4, identifies the points at which the Commission will issue its Decision Papers. The Commission may also respond to any requests from the Customer Forum for further information or analysis.

The Commission will again be minded to accept an agreement between the Customer Forum and Scottish Water that is consistent with the ranges set out in the final iteration of its Decision Papers.

The timeline also sets up many more opportunities for bilateral and multi-lateral discussions between stakeholders. These meetings should ensure that all stakeholders are fully informed on the development of the discussions between Scottish Water and the Customer Forum. The Commission may draw on these meetings in finalizing its decisions.

The role and remit of the Customer Forum

The Co-operation Agreement with Citizens Advice Scotland and Scottish Water is included as Appendix 2. The new Forum will again act as a conduit for the views of customers. We are keen that it engages closely with both Scottish Water and CAS/CFU³⁴ on the programme of customer research for the Strategic Review of Charges 2021-27. For the first time, and with the assistance of the OECD, the partners will use behavioural insights to improve both the focus on and understanding of customers³⁵. Behavioural insights are particularly important as they can help understanding of how customers understand and will respond to information and issues. As such, services can be tailored to be more effective. The Forum will also be able to commission its own research.

³⁴ The Consumer Futures Unit (CFU) within Citizens Advice Scotland (CAS)

³⁵ The OECD has recently published a detailed review of behavioural insights. See a recent publication 'Behavioural Insights and Public Policy: Lessons from around the world' March 1, 2017

The 2021-27 Customer Forum will comprise 10 members (including its Chair). The Chair will appoint 3 members from the previous Customer Forum; licensed providers will nominate three members; and CAS will administer an open recruitment process to select the remaining members. The process of recruitment is already underway. It is expected that the Customer Forum will be formally established in May 2017.

Figure 2 illustrates the difference between the remit of the Customer Forum and the broader role of CAS. The Customer Forum's scope of activity is limited by the statutory remit of the Commission. The Customer Forum has therefore to operate within the parameters set by Ministers through their policy statements and by the Commission through its decisions (in line with its statutory duties) on acceptable outcome ranges.

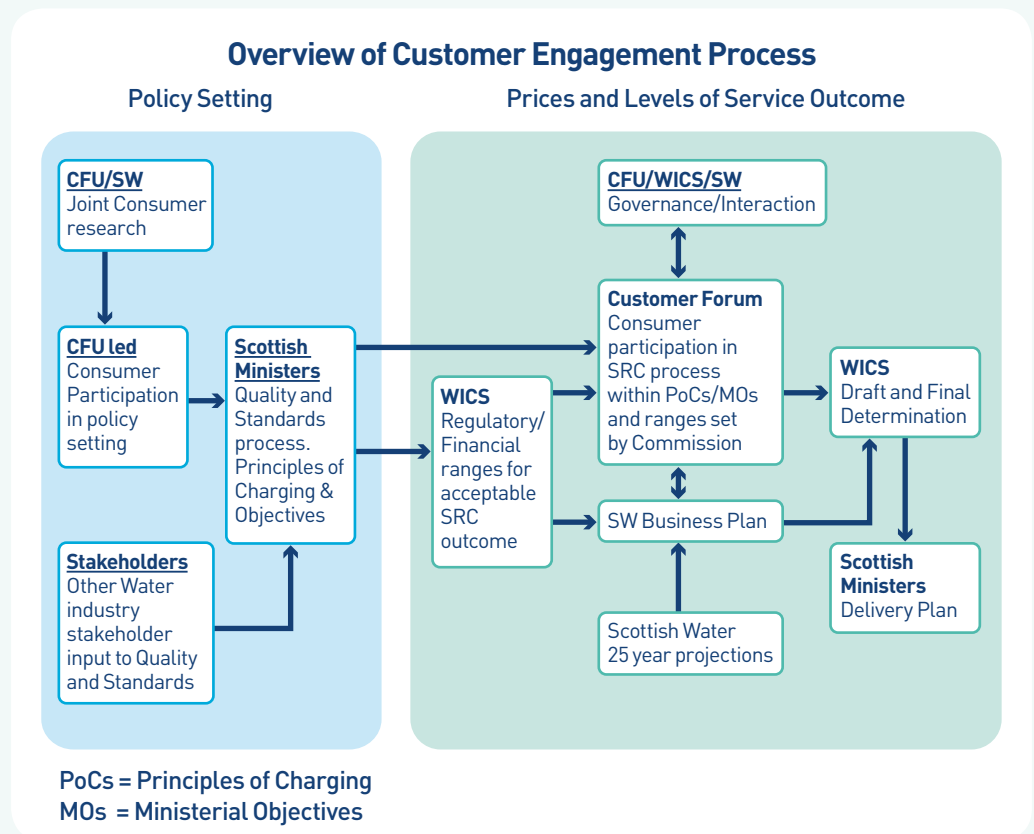
The Customer Forum will have no remit to influence Government policy and should focus on ensuring that it strikes the most appropriate agreement possible within the existing policy framework and the ranges for the inputs to the Strategic Review. The aim is for the Forum to reach out more to communities across Scotland. The level of resourcing for the Customer Forum will reflect this increased level of engagement.

Unlike the Commission, CAS has a clear policy role and is able to conduct research to influence Government policy on behalf of consumers. CAS provides input to the 'Quality and Standards' process, which, in turn, informs the Scottish Ministers when they set their Objectives and the Principles of Charging.



The Customer Forum will reach out more to communities across Scotland.

Figure 2: Overview of the customer engagement process: the respective roles of CAS and the Customer Forum



The resourcing of the Customer Forum

For the Strategic Review of Charges 2021-27 we have allowed for a larger budget (£875,000 over three years). This increase reflects:

- greater involvement in joint working with Scottish Water and the Consumer Futures Unit on customer research;
- an increased frequency of meetings with stakeholders;
- more engagement with communities;
- the use of behavioural insights; and
- an allowance for independent research by the Forum.



We expect Scottish Water to take full responsibility for its plans.

The increase in the level of resources available to the Customer Forum should allow it to reach out to communities across Scotland. In our view, there is substantial scope for the Customer Forum to work with Scottish Water to understand the views of customers and communities.

“Seek Trust but Expect Verification”

As we noted previously, we expect Scottish Water to take full responsibility for its plans. It should be able to provide evidence why its approach is efficient and how it considers it is meeting the needs of its customers. In short, it should act as though it has the same direct accountability to its customers as any truly customer focused business that is not subject to economic regulation. Scottish Water should expect its regulator and its customers to consider carefully whether it is offering the expected level of service for an appropriate price.

In a competitive market, a company will always seek to respond to the evidence of its customers' behaviour. It will seek out evidence. In a similar way, the Customer Forum should seek to put itself in a position that it can provide evidence to Scottish Water to substantiate its views. This could be particularly important if the Customer Forum were to disagree on some issue with Scottish Water.

The timeline for the engagement process

We have developed the timeline for the Strategic Review of Charges 2021-27 to allow for as much engagement with customers and communities and discussion between stakeholders as possible. It sets out the key interactions between the Customer Forum, the Commission and other stakeholders. It also clearly indicates the points at which the Commission will publish its Decision papers. The timeline is set out in Appendix 4.

The Consumer Futures Unit and Scottish Water are now beginning their customer research activities for the Quality and Standards process and Strategic Review of Charges 2021-27. The new Customer Forum will be able to engage actively in this process as soon as it is established.

What will success look like?

We want to build on the success of the innovative Customer Forum approach that we developed for the 2015-21 Strategic Review.

Scottish Water's primary focus should be on its customers. It should seize the initiative to take full responsibility for serving its customers as effectively as it can. The Commission understands that the price setting process has to be as clear as possible. The proposed timeline offers greater clarity of the role of the Commission and sets out when the Commission will make its decisions on the appropriate ranges for inputs to the Strategic Review of Charges. More frequent engagement of the Customer Forum with the Commission and other stakeholders should improve the transparency of the process and ensure that the views of all parties are appropriately taken into account.

The Customer Forum should be even more integral to the price setting process than it was in our last price review. There will be better co-ordination of research activity, including the use of behavioural insights, and a significantly increased focus on the views of customers and communities. We also expect that the slightly revised membership structure and the opportunity for household customers and licensed providers to seek nomination to the Customer Forum should improve its legitimacy and effectiveness.

The use of behavioural insights should be embraced and should feed through into more focused initiatives to meeting the needs and expectations of customers.

Conclusion

The Commission wants to build upon the customer engagement model that it adopted for the 2015-21 Strategic Review of Charges. The Customer Forum did a good job. Customers got a better deal than they would have done if the Commission had relied upon a traditional approach to regulation. There is more that we can do. Further empowering Scottish Water should increase its focus on customers. But with empowerment comes scrutiny and Scottish Water should expect that both the Commission and the Customer Forum will look at its plans carefully. Our intention is to create a regulatory framework in which Scottish Water will take the initiative to provide robust evidence that it is delivering for its customers.

5

Incentivising innovation

This chapter sets out the steps that we are taking to ensure that Scottish Water can meet the expectations of customers. Customers will likely expect that services will continue to improve and remain as affordable as possible. Given the challenges that lie ahead, this will likely require Scottish Water to become more innovative. In our view, becoming more innovative will underpin the value for money that customers will receive in future. At the last Strategic Review of Charges, we focused on trying to reduce or remove the regulatory barriers to innovation. At this Review, we plan to go further – it will now be for Scottish Water to demonstrate that it is meeting the needs of its customers and is positioning itself as well as possible for the challenges that lie ahead.

Introduction

Traditionally the water industry in the UK has been characterised by a low appetite for risk and an understandable bias towards more traditional ‘civil engineering’ approaches³⁶. These traits potentially create a barrier to innovation. At the last Strategic Review of Charges, we identified and addressed a number of regulatory factors, which contributed to any reluctance to take risks or to innovate. In this chapter, we will review the potential barriers to innovation; explain the steps that we took at the last price review; and the steps that we are now taking to ensure that Scottish Water is well placed to meet the demands of its customers both now and in the future.

Barriers to innovation

Water companies rightly value their reputation. One consequence of this may be a risk-averse approach. There is clear reputational damage associated with a service level failure or a shortfall in achieving the required compliance with environmental and water quality standards. Such shortfalls tend to be very visible to customers, special interest groups and politicians at both a local and a national level.

Companies’ focus on achieving statutory compliance in drinking water quality and environmental statute has resulted in a strong incentive to use tried and tested solutions. They have historically been quite reluctant to rely on more operationally based solutions.

When regulation was first introduced, the industry had to deliver a substantial amount of investment to meet water quality and environmental standards. The regulatory framework encouraged a bias towards capital expenditure (initially quite deliberately) to ensure that these higher standards were delivered. It did this by allowing companies to earn a return on each new investment that they have made. In short, companies earned more profit by investing more in capital solutions.

³⁶

As discussed later, this bias was in part due to the regulatory approach to price setting.

Regulators typically reset prices every 5 to 8 years. This has two effects.

1. There is a reduced incentive to think about the long term (not least because there is no certainty about the level of resources that will be available); and
2. A regulated company cannot be certain that any project, which only reaches pay back after the end of the regulatory control period, will ever reach pay back. Short pay back periods would make it difficult for a water company to justify significant asset rationalisation (because such an approach would typically require much longer to pay back). In essence, projects that have a positive Net Present Value (NPV) are not being adopted because of uncertainties created by the regulatory framework.



Adopting more innovative approaches will be essential to meeting a number of the challenges facing the water industry.

There has, more recently, been some recognition by other regulators of a bias towards capital expenditure. They have sought to address this by developing an approach that looks at operating costs and capital expenditure together. They refer to these as TOTEX (total expenditure). TOTEX allows a company to add operating as well as capital expenditure to its RCV and to choose the rate at which it 'runs down' the TOTEX addition. In our view, TOTEX only goes some way to reduce barriers to innovation or encourage operating expenditure solutions to achieve the desired outcomes. It is only fully effective if pay back on the new approach is achieved within the regulatory control period and there is a broad equivalence in the implementation risk of the different approaches. We will continue to follow a cash based approach, as discussed in Chapter 7, as distinct from this TOTEX approach.

As a public sector company, Scottish Water does not have the same incentive as its privatised neighbours to maximise profit by seeking to invest more capital. However, it is, arguably, more exposed to the constraints of the regulatory and governance framework. It cannot borrow freely. It also does not have a non-regulated holding company³⁷, which could 'own' projects that are longer term but have a clearly positive NPV.

Customers should, however, still be able to expect Scottish Water to pursue projects that have a positive NPV. They should also expect Scottish Water to identify opportunities to share risks across its portfolio of projects.

Customers are sensible. They see the benefits of innovation but also understand that not every innovative approach will be successful.

Scottish Water should always be able to pursue projects with a positive NPV and they should always look to minimise the net present cost of any project. As the economic regulator, we should maintain a regulatory framework that allows Scottish Water the opportunity to make this happen.

The challenges that lie ahead

In our view, adopting more innovative approaches will be essential to meet a number of the challenges facing the water industry. These include:

- the need to mitigate and to adapt to the potential impacts of climate change; and
- the longer term and less certain nature of future priorities.

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Separately funded and with separate access to finance.



Resilience in service delivery – both in water and waste water activities – is therefore likely to be critical.

The Scottish Government's Climate Change Scotland Act 2009 commits to a major reduction in Scotland's carbon emissions. Scottish Water is a major user of energy, so will have a role to play in supporting the achievement of these targets. As such, Scottish Water has to be acutely aware of its carbon impact. Scottish Water is not just a large energy user, the raw materials that it uses and its substantial civil engineering programme have a high level of embedded carbon. Scottish Water will likely have to consider other, non-capital based approaches to deliver improved compliance or levels of service if it is to contribute further to the reduction of carbon emissions in Scotland.

Scottish Water will also have to adapt to the effects of climate change. There appears to be a broad consensus that climate change will result in more frequent extreme weather events. Customers are unlikely to accept interruptions to supply. Resilience in service delivery – both in water and waste water activities – is therefore likely to be critical. Meeting this challenge will require innovative approaches to be adopted if the impact on customers' bills is to be kept to a minimum.

Our approach at the last Strategic Review of Charges

At the last Strategic Review of Charges, we made a number of changes to the regulatory framework to reduce or remove the financial constraints to innovation. This section reviews the changes that we made. These changes were:

- We stopped making any distinction between operating and capital expenditure; and
- We moved to a six-year regulatory control period with a rolling investment programme to allow Scottish Water to update their investment programme on a three-yearly cycle. The aim was to allow for flexibility in responding to new information coming from environmental studies.

We also introduced two measures that were designed to encourage the use of innovative solutions: a concept of risk-adjusted costs and a commitment to allow for long-term pay back on defined projects.

Risk adjusted costs and innovation

The first measure allowed Scottish Water to add the costs of any additional risk to the underlying cost of meeting a defined outcome. This was designed to allow easy comparison of alternative approaches using the same discount rate to calculate the NPV. We were recognising that adopting innovative approaches for any portfolio of projects will result in some failures. The idea was that the additional provision for risk would allow more traditional solutions to be implemented where necessary.

In order to take forward this risk-adjusted cost approach, Scottish Water would have to demonstrate that the total cost of the portfolio of projects (including the costs of the risk-adjustment) would be lower than that of the next best alternative. We suggested that Scottish Water and the Customer Forum could agree to ring-fence the additional risk allowance in a 'risk reserve' to ensure that Scottish Water always had the cash resources it may require to deliver the required outputs efficiently and effectively.

Allowing for long-term pay back initiatives

The second measure was designed to allow Scottish Water to pursue long-term pay back initiatives. The Commission recognised that savings should be ring-fenced until pay back on the initial investment was achieved.

Previously there was no incentive to undertake long-term initiatives where the pay-back extended beyond the regulatory control period. The Quality Regulators had an important role to play in helping Scottish Water understand the risks of different approaches and where there was an opportunity to opt for a more innovative solution.



Allowing Scottish Water to agree with the Customer Forum to ring-fence the financing of innovative and long-term positive NPV projects was a clear step forward.

What worked well?

Scottish Water's business plan contained some good examples of innovation. There is clear practical progress in its partnerships with universities, its supply chain and the Hydro Nation Water Innovation Service.

Allowing Scottish Water to agree with the Customer Forum the ring-fencing of the financing of innovative and long-term positive NPV projects was a clear step forward.

What should we do better?

Scottish Water's plan could, perhaps, have gone further in taking advantage of the changes set out above. With hindsight, there was probably more that we could have done. For example:

- the timing of the publication of our methodology may have given Scottish Water insufficient time to embed the new regulatory incentives in its business planning processes;
- the lack of clarity about regulatory process, such as guidance on how the measures would work in practice may have caused uncertainty within Scottish Water; and
- we could, perhaps, have been clearer on how the efficiency benefits could be used to benefit customers.

It is not clear that the regulatory interventions had the desired effect. It is likely that taking a further step towards fully empowering Scottish Water to take hold of opportunities to be innovative may be more effective.

What do we plan for the Strategic Review of Charges 2021-27?

The Commission and Scottish Water established an Innovation Panel in July 2013. It had four independent members. The Commission, the Scottish Government and Scottish Water also attended its meetings. The Panel's remit was to consider what could be done to encourage further innovation in the Scottish water sector.

The Panel considered that there could be a more co-ordinated approach to managing risk and driving innovation across the Scottish Water industry. The absence of a shared vision on key issues such as risks and, in particular, trade-offs between cost and risk was likely to act as a barrier to innovation.

Figure 3: Collaborative approach to innovation and risk



There is a need to encourage a culture of innovation across all stakeholders.



The panel recommended that there was a need to encourage a culture of innovation across all stakeholders. In particular, the panel suggested that it was important that customers understand the risks that are being managed on their behalf and the impact that different approaches (with different risk profiles) could have on their charges. This would also be consistent with the Consumer Principles set out by CFU³⁸.

The panel did not reach any conclusion on how this consensus should be developed. It also did not address roles and responsibilities. In our view, the onus should be on Scottish Water to demonstrate to its customers and stakeholders that it is taking all the steps that it reasonably can to meet current and future challenges in a cost-effective way.

It is not clear that the creation of individual measures to encourage innovation could ever be fully effective. Inevitably, and to varying extents, such interventions can reduce the accountability of Scottish Water to its customers and increase the attention that Scottish Water pays to the expectations of its economic regulator. This is undesirable and inconsistent with our desire to see Scottish Water focus on serving its customers. The aim, instead, is for innovation to be an integral part of Scottish Water's approach to meeting the needs of its customers.

We plan to use a different approach at this price review. We will ask Scottish Water to propose an allowance for capital expenditure in both its strategic projections and in its draft business plan. The Commission's advice to the Customer Forum will primarily focus on the deliverability of large capital expenditure programmes and the implications for prices of different sizes of capital programmes.

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The CFU consumer principles are set out at www.cas.org.uk/about-us/social-policy/consumer-futures

The Output Monitoring Group (OMG) currently brings together Scottish Water, the Water Industry Commission for Scotland, the Drinking Water Quality Regulator, the Scottish Environment Protection Agency and the Consumer Futures Unit of Citizens Advice Scotland to ensure that Scottish Water is making appropriate progress towards the timely delivery of the objectives of the Scottish Ministers. The OMG assesses Scottish Water's progress in delivering the key milestones of the investment programme against its targets set out in the Delivery Plan and publishes reports on a quarterly basis.

Under our planned approach, Scottish Water will have to consider how it can demonstrate to OMG and, in particular, the Quality Regulators that it is making sufficient progress towards meeting the outputs required by the objectives of the Scottish Government. In our view, there should be no significant difficulty in adapting the Overall Measure of Delivery to this new approach.

Scottish Water may see benefit in working with the Quality Regulators to increase their understanding of costs and risks. In particular, there may be scope for greater collaboration before projects are defined and scoped. Such collaboration could also extend to the 'host'³⁹ community. The benefit to the Quality Regulators could be that resources are freed up which would allow more of their priorities to be addressed more quickly.

How will this approach benefit customers?

It is clearly in the customers' interest if Scottish Water can find ways to be increasingly innovative.

Our planned approach is consistent with 'Seek Trust but Expect Verification'. Scottish Water will carry the responsibility for explaining to its customers why the cash allowance it is proposing in its business plan is required and what the risks to delivery are. Similarly, it will have to justify the extent to which it uses innovative approaches. Scottish Water would also, under this approach, be responsible for justifying the level of Government borrowing that they believe to be required, within the limits set by Ministers. This should benefit customers in two ways. Firstly, it should ensure that Scottish Water has had to think hard about how it has made space for innovation in its operation of the business. Secondly, it requires Scottish Water to find appropriate ways to communicate its initiatives to its customers.

What will success look like?

The Commission will provide advice to the Customer Forum on the rigour of the justification for the proposed level of capital expenditure included in Scottish Water's business plans. Our commentary could cover issues such as the proposed approach to:

- capital maintenance;
- growth;
- taking back the waste water and sludge PFI contracts;
- innovation;
- defining projects;
- new borrowing; and
- evidencing efficiency.



It is clearly in the customers' interest if Scottish Water can find ways to be increasingly innovative.

³⁹

Where an asset intervention may be required.

During the price setting process, we would expect Scottish Water to work with its stakeholders and the Customer Forum to understand what evidence it should be ready to produce to show that it is appropriately open to innovation and that it is spending customers' money in an efficient and effective way.

One possibility could be for Scottish Water to publish its investment appraisals for all individual projects with a whole life NPV of, say, greater than £10 million. It could similarly propose some method of aggregating smaller projects such that the appraisal of options for these outputs may be understood and appropriately reviewed. Such information is likely to be essential to building the level of trust that Scottish Water should seek to establish.

We understand that this proposal is very different to what currently happens. The publication of appraisals, however, would likely be a very effective way of providing the evidence that is required to establish and maintain trust and be resilient to whatever verification may come later.'

Under this approach the ball is firmly in Scottish Water's court. It should take this opportunity to demonstrate that it is looking beyond compliance and is focused on delivering the very best for customers and for Scotland.



Under this approach the ball is firmly in Scottish Water's court.

Conclusion

The Scottish water industry has successfully improved its performance whilst reducing costs. It has shown a willingness to innovate but again there is no room for complacency. At the last price review we took a number of steps that were designed to encourage Scottish Water to seek out opportunities to innovate. Scottish Water responded well but the innovation panel concluded, correctly, that it could have done more.

On reflection, we can see that any regulatory action designed to encourage Scottish Water to innovate can potentially become an end in itself rather than a means to ensure that customers in Scotland receive better value for money.

The steps that we are planning to take should empower Scottish Water and allow it to demonstrate that it is focused on doing the best it can for its customers and for Scotland. It is now the responsibility of Scottish Water to demonstrate that the trust of its customers and stakeholders is fully justified.

6

Future proofing service levels: improving asset understanding and monitoring

Customers take it for granted that Scottish Water will at least maintain current levels of service. Moreover, they would expect that today's approach to the management of assets today is not storing up problems and price rises for the future.

In practice, it is very difficult to assess how much should be spent to achieve a given baseline level of service and to maintain the condition of the assets. This chapter outlines the challenges that exist in ensuring that service and asset condition levels are maintained. It then sets out our planned changes to the regulatory framework and monitoring regime to ensure that the right approaches, financing and incentives are in place to maintain environmental compliance and levels of service to customers over the long term.

Introduction

The level of service that customers experience is directly related to the condition and performance of the vast network of water and wastewater assets that Scottish Water operates. These assets have very varied lives, from a few years for IT equipment and vans to more than 100 years for sewers, water mains and reservoirs.

In the water industry, the term 'capital maintenance' has traditionally been used to define the on-going investment required to maintain existing levels of service to customers and to protect the environment. Capital maintenance can involve the replacement of worn out plant and equipment at the end of its useful life or interventions to ensure that the asset does not deteriorate to the point where it needs to be replaced.

The extended lives of these assets make it difficult to demonstrate to customers the value of the assets that are used to provide the service that they enjoy. For example, the water main that serves a particular street may not be replaced during the lifetime of a resident of the street - even if she were to live her entire life in the same house. Customers benefit from the economic value provided by each asset throughout each year of the asset's useful life, and, in paying their water charges, contribute to the service provided. In essence all charge payers are contributing into a fund and Scottish Water uses the proceeds to maintain its infrastructure as well as it can, with a primary focus on maintaining and improving service levels.

Regulators across all asset-intensive industry sectors appear to have found it challenging to know how much expenditure to allow for. Companies have generally not been able to evidence many of their requests for additional capital maintenance and some have even paid out extra allowances in dividends to shareholders. Paying dividends with funds allocated for capital maintenance purposes has, without question, negatively impacted all (private and public) companies and customers. Trust has been lost, or at least, markedly

reduced. Regulation became more sceptical of companies' case to invest and there was less immediate focus on what may be best for customers.

The result has been that regulators and regulated companies have defaulted to a shorter-term approach of setting levels of expenditure. Regulators have focused primarily on the asset performance information provided by the regulated company. This approach, in effect, assumes that performance and condition are effectively 100% correlated. It also assumes that there is a robust understanding of the performance implications of maintenance expenditure. It is a 'pay the minimum that is demonstrably required' approach. It brings the obvious risks to both current and future customers from long-term deterioration of the condition of the assets. In this chapter we will examine these issues in more detail and set out our planned changes to our regulatory approach. Customers will want to be confident that service levels can and will be maintained over the longer term.

The information required to support higher levels of capital maintenance is not too difficult to define – Ofwat's MD161⁴⁰ letter did a good job of setting out what would be required in a robust economic case for additional maintenance. Both regulator and regulated company, with the benefit of hindsight, could have focused more on developing this economic case.

It is difficult to monitor consistently and reliably the condition of long life assets, most of which are underground. The use of statistics can be helpful, but any predictive insights can apply only at an aggregate/ portfolio level. They cannot provide a road map for precisely what needs to be done. There is therefore no real long run alternative but to improve the monitoring of the condition of assets⁴¹.

It is even more difficult to demonstrate the impact on service levels of higher, or lower, capital maintenance expenditure. Recent research we have carried out with senior executives across a wide range of asset intensive sectors appears to confirm the high degree of uncertainty that exists in regulated sectors around whether the current levels of expenditure in this area are adequate. There appears to be little question that more will need to be done in the future. Given the history of capital maintenance, the challenge Scottish Water faces in seeking trust is even more daunting. The proportion of customers' charges that go towards maintaining assets makes developing trust in this area essential.

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Ofwat publication, "MD161: Maintaining Serviceability to Customers" (12 April 2000)

41

It is not clear that statistics are particularly helpful when we are thinking about the 'end of life' for some of the assets with the longest lives. It is not clear that we have experienced sufficient examples of failures to draw reliable inferences.

Our approach at previous Strategic Reviews of Charges

When Scottish Water was formed in 2002, it was clear that very little was being spent on capital maintenance. The focus was on the investment required to meet the tighter water quality and environmental standards required by legislation.

This was a clear concern for the Water Industry Commission for Scotland. However, the Commission could not allow for expenditures that Scottish Water was unable fully to justify. In the first three Strategic Reviews of Charges (2002-06; 2006-10; and 2010-15) the Commission was concerned to identify weaknesses in the asset performance and condition information available to Scottish Water. We had to use quite high-level comparisons to try to ensure that we made a reasonable allowance for capital maintenance in setting charges. We relied upon a review of Scottish Water's 'bottom up' assessment of the proposed programme of work by the independent industry Reporter, and a range of alternative 'top down' techniques such as econometric modelling and the use of Modern Equivalent Asset Value (MEAV) information.

Between 2002 and 2015, Scottish Water's capital maintenance expenditure was broadly stable at around £240 million to £250 million a year in real terms. However, when efficiency improvements are taken into account, there was a significant increase in maintenance activity over this period. This increase in expenditure on capital maintenance reflected:

- **Catch-up:** An ageing asset base requires more interventions to maintain service levels;
- **Growth:** Growth in population and/or volumes supplied/ collected leads to more asset interventions;
- **New Standards:** The more modern assets required to meet higher environmental standards require more maintenance; and
- **Shorter life assets:** Many of the solutions used to meet tighter environmental and water quality standards have shorter asset lives.

However, given the investment in meeting higher quality and service standards that has taken place in the last 20 years, it is inevitable that expenditure on capital maintenance will likely have to increase. Increased expenditure in this area may be offset if the capital enhancement programme begins to decline in the future. This explains the importance that we attach to innovative approaches and operational solutions. Such solutions could reduce expenditure on enhancement that would otherwise have been required.

Where are we now?

Scottish Water's business plan for the most recent regulatory control period 2015-21 proposed significant increases in capital maintenance expenditure, representing a 12% increase over the average level in the 2010-15 period in real terms. Scottish Water reported that this increase was driven by a rise in forecast asset replacement activity, reflecting the extensive investment made on new and enhanced assets over the past 20 years, including many high technology assets with shorter asset lives.



It is inevitable that expenditure on capital maintenance will have to increase.

In its assessment of capital maintenance expenditure requirements, Scottish Water used two modelling approaches, which it developed in partnership with the University of Edinburgh and the University of Strathclyde:

- **Asset Risk Models:** Asset risk models use past asset failure information to estimate the reliability of assets and the impact a failure will have on customers and costs. These models optimise both operational and asset maintenance activities to identify the lowest cost way of delivering a desired level of service at a chosen probability of outcome. These models were mainly applied to water mains and sewers; and
- **Asset Stewardship Models:** Asset stewardship models forecast the transition of assets through six different 'condition' states and assess the benefits of different types of intervention over a 25-year time span. These models were applied to non-infrastructure assets.

The models were peer reviewed by Professor John Andrews of the University of Nottingham, who stated that Scottish Water's modelling puts it at or near a leading position among UK water companies and that the models compare well with those used in other infrastructure intensive industries.

Following careful scrutiny of Scottish Water's approach to capital maintenance, including a review by the Independent Assuror, the Commission concluded that Scottish Water's proposal for an increase in capital maintenance appeared to be justified. The Customer Forum also supported this additional expenditure.

What worked well?

In recent years Scottish Water has made significant progress in understanding its assets.

Traditionally, service levels have formed part of the 'Overall Performance Assessment' (OPA) measure, which has been used throughout the water industry as a general measure of companies' performance. In the 2015-21 Strategic Review of Charges, the Customer Forum agreed with Scottish Water a range of new, more targeted, customer service measures including the Customer Experience Measure (CEM) and the High Esteem Test. Performing well against these benchmarks will require more effective maintenance of assets.

Scottish Water is also working with the Commission to establish an Asset Health Indicator in an attempt to establish the long-term trend in the age and condition of the principal classes of assets. The development work in this area has shown the extent of the challenge in collecting the necessary information and in establishing clear trends from the information that becomes available.

We recognise the progress that Scottish Water is making to determine the risk categories of their assets, based on an assessment of the likelihood and impact of failure.

As part of this exercise they are allocating assets into one of three categories:

- Critical to service levels (and therefore must not be allowed to fail);
- Assets that should be pro-actively managed; and
- Assets that can be allowed to fail and can be fixed when they do fail.



In the 2015-21 Strategic Review of Charges, the Customer Forum agreed with Scottish Water a range of new, more targeted, customer service measures.



We have sought to understand better the challenge of maintaining service levels over the longer term and the effectiveness of the current regulatory framework in this area.

These initiatives will allow the company to prioritise maintenance investment on those assets that are most critical to maintaining service levels. It will allow them to target the expenditure more effectively. The resulting benefits have been reflected through continuing strong performances in both the OPA and CEM measures, as reported in the Commission's annual performance reports. In addition, the set of annual performance measures which are monitored by stakeholders through the Outputs Monitoring Group (OMG) indicate that year on year performance in critical service areas remains on or above target. This level of performance is being achieved within the efficient levels of investment set out in our final determination for the 2015-21 regulatory control period.

It would therefore seem reasonable to assume that the regulatory framework is effectively awaiting for the required level of expenditure and activity to maintain service levels in the short term.

What should we do better?

It is becoming increasingly evident that the expenditure and activity levels needed to maintain service levels in the future are not well understood. There will need to be changes to the current regulatory framework to ensure that these needs are addressed appropriately. There is an increasingly obvious mismatch between economic and accounting depreciation and the actual operational effectiveness (and, likely, condition) of assets over time.

It is difficult to forecast what levels of capital maintenance may be appropriate in future. One key reason for this is that there is little experience of 'end of life' for the long-life assets (which comprise the largest proportion of the optimised replacement cost of the assets). This lack of experience of 'end of life' limits the extent to which we can rely on statistical modelling. There are other indicators that may help build understanding, such as the MEAV of Scottish Water's assets.

We have sought to understand better the challenge of maintaining service levels over the longer term and the effectiveness of the current regulatory framework in this area. Our work with Indepen focused on sectors with long life assets, seeking to establish the extent to which there is a detailed understanding of asset condition, risk and service level maintenance.

We will shortly publish the findings of this research. The interviews appear to confirm that across most regulated sectors there is an incomplete understanding of the level of expenditure required to maintain long-term service levels. There is also a general consensus that the current regulatory frameworks are not providing the right incentives to address this issue. This is not an issue that is confined to Scottish Water or to the regulatory framework in Scotland.

Both Scottish Water and the Commission are committed to ensuring that the right steps are taken to manage the system on behalf of customers in Scotland. The Scottish Government has highlighted the importance of effective capital maintenance in its commissioning letter for the Strategic Review of Charges 2021-27.

Impact of the Regulatory Framework

Through both our advisory panel discussions over the last year and the structured interview sessions, we identified a number of issues with the current regulatory framework that could limit efforts to maintain long term service levels. These can be broadly grouped into financial, operational and monitoring issues.

Financial issues

The regulatory framework has focused on establishing a 'hard budget' constraint for the regulatory period within which companies must operate. This approach does not easily lend itself to appropriate understanding and treatment of long life assets where investment is unpredictable and could use up a significant proportion (potentially all) of an annual allowance on one project.

In particular, the current RPI-X model does not appear to be well suited to incentivise appropriate levels of capital maintenance particularly for the replacement of long life assets. It is an area where, historically, various companies have been able to reduce expenditure if resources in other areas were tight. The apparent lack of an immediate impact in performance from a change in capital maintenance would largely explain this observed behaviour. However, such reductions in expenditure can only postpone the investment required. They are likely to have a detrimental impact on the long-term performance and resilience of the asset base and increase the costs in the future. This is bad for customers.

RPI-X, combined with the hard budget constraint, has led to this 'pay the minimum that is demonstrably required' approach in the industry, which does not sit comfortably with any long term whole life assessment of the cost or the need to make long term provision for asset replacement.

Operational issues

Customers would expect Scottish Water to maintain service levels sustainably. Maintenance activity should be planned to reflect the lowest whole life cost of maintaining service levels, rather than the lowest cost during any particular regulatory control period. Replacement activity is most economic at the point where the operational costs of ensuring that an asset can perform adequately exceed the annualised costs of its whole life replacement.

There is more to be done. The water industry will need to improve the information that it has on asset performance, risks and condition. It should expect to have to be able to demonstrate to customers and other stakeholders that it is managing its assets in the most effective manner possible. This is likely to require a robust understanding of the asset life cycle of each asset, the failure modes and the consequences of failure of all types of critical assets.

Monitoring issues

The nature of the water industry makes it difficult to assess overall 'asset health', given that customer service is dependent on assets with a wide range of forecast lives. Most customer service measures, such as the OPA and CEM, focus on short-term indicators. Our work with Scottish Water to develop a longer term 'Asset Health Indicator' may ultimately allow the use of output based measures to identify long-term asset replacement requirements.

Going forward, the monitoring mechanisms need to be able to identify the impact of capital maintenance expenditure over the long term and provide confirmation that problems are not being stored up for future generations.



Customers would expect Scottish Water to maintain service levels sustainably.



This is likely to require a robust understanding of the asset life cycle of each asset.

Summary

The impact of capital maintenance both on customers' bills and potentially their daily life requires the water industry to make significant progress in this area. Customers have a right to expect that assets are being maintained appropriately, and that problems are not being stored up for the future.

What do we plan to do for the Strategic Review of Charges 2021-27?



Only an open dialogue will allow the issue of capital maintenance to be addressed effectively.

We are continuing to work closely with Scottish Water on capital maintenance, recognising that all stakeholders have a common interest in understanding the appropriate level of expenditure. In our view only an open dialogue will allow this issue to be addressed effectively.

Our plans focus on 3 key areas:

- Encouraging Scottish Water to achieve a better understanding of the assets and their impact on maintaining service levels;
- Ensuring the regulatory framework provides for efficient and sustainable financing of long term service maintenance; and
- Developing the monitoring mechanisms to provide reassurance for all stakeholders that problems are not being stored up for the future.

Looking at each of these in turn:

Understanding the assets

We are confident that Scottish Water understands the importance of maintaining the condition and performance of its assets over the long term. Strategically, the Modern Equivalent Asset Value could be a useful indicator of whether assets are being prudently maintained and potential future expenditure appropriately allowed for.

The MEAV is currently estimated (by Scottish Water) to be around £58 billion⁴². Such valuations have typically been viewed (probably correctly) with some scepticism – not least because some regulated companies have sought to use inflated values and unrealistic asset lives to justify much higher spending on asset maintenance.

To be useful, Scottish Water would have to be able to build a consensus amongst its stakeholders that its estimates were as good as it can reasonably make them and that it will adjust these valuations as further information becomes available.

⁴²
In the year 2012-13.



Taking back control of the PFI contracts will be a challenge.

Developing such a consensus would require consideration of issues such as:

- What is the current true value of the assets in use? What depreciated value should be targeted (by asset category)?;
- How should the replacement of assets be optimised? Optimisation is not just a function of technology; it is also a function of what customers would find acceptable and the higher environmental and public health expectations of society today;
- What is the impact of recent improvements to meet higher environmental and public health standards on the wider asset base?;
- How should the likely redundancy in the current system be taken into account?; and
- How should the reduced resilience in the system (due to growth or other factors) be taken into account?

Properly understood, the MEAV could give a broad indication of the actual assets that are employed by the industry and are required for the future.

Even if a consensus can be developed about the level of overall average spending, there is still a significant challenge. An individual asset failure could still be both unexpected and expensive. We also have only limited knowledge about what the consequences of a failure could be on the daily life of a community served⁴³.

Scottish Water has taken a number of pro-active steps to begin to understand the risks of the many systems that they operate. They are thinking about the appropriate mitigations that are available to them.

For example, during the 2021-27 regulatory period the first of the Private Finance Initiative (PFI) wastewater treatment sites will come to the end of its contract life. Scottish Water has identified the requirement to develop comprehensive long-term asset plans for these sites. This could provide a useful template, which will help inform the approach to developing asset plans across Scottish Water's network. We will work constructively with Scottish Water, along with SEPA and the Scottish Government, to extend this approach to the other non-PFI sites.

In discussion with Scottish Water, there appears to be a five step process:

- Scottish Water understands fully the maintenance profile at the PFI sites and the lessons that can be learned;
- Scottish Water confirms its understanding of the MEAV of its assets, the proportion of expended life and the most important failure modes and consequences;
- Scottish Water continues to develop detailed asset maintenance plans covering all its 'critical assets'. We recognise that this will take some time and will likely not be complete before the next regulatory control period;
- Scottish Water sets out its plans to improve its understanding of assets in the second 'pro-active management' category; and
- Scottish Water reviews the assets that it considers can be fixed if and when they fail. They will need to ensure that customers and other stakeholders understand and agree with these judgments. Scottish Water's aim must be to ensure that levels of performance to customers are, on the average, maintained or improved.

These steps will result in a better understanding of long term asset replacement needs and is likely to impact the level of funding required to ensure the long-term sustainability of the industry.

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Recent flooding events and the closure of the Forth Road Bridge and of the Winchburgh tunnel on the main Glasgow to Edinburgh train line give some indication as to just how much we take our infrastructure for granted.

Providing for sustainable financing of service level maintenance

Earlier in this chapter, we explained the difficulty of predicting how much expenditure will be required and when it will be required. We also established that there are strong indications that a higher level of spending will almost certainly be required over the long run if service levels are to be safeguarded - even when we allow for efficiency improvements and more innovative approaches.

Customers currently pay for capital maintenance through the depreciation charge. In theory, depreciation should be broadly equivalent to expenditure on current maintenance and asset replacement. There is no compelling evidence that current allowances for capital maintenance are too low – although there are occasional (and unfortunately, repeated) asset failures. However, it does appear to be clear (for example, current replacement rates suggest unreasonably extended asset lives) that there will need to be higher levels of capital maintenance and asset replacement expenditure in the future. Such higher expenditure would, everything else being equal, mean higher bills. There is, therefore, a question as to whether the costs of asset use are being equally allocated across different generations of customers. It seems likely that these costs may be being skewed to future generations.

As explained in the previous chapter, we will seek to put the onus on Scottish Water to justify its level of allowed for capital expenditure. It will have to think carefully about how it maintains its assets both now and in the future. We can see three options:

- Scottish Water could build up balance sheet reserves for future expenditures (keeping prices more stable); or
- It could operate a 'pay as you go' approach that is designed to meet the likely requirements identified at the start of each regulatory control period; or
- It could continue to operate the 'pay the minimum that is demonstrably required' approach.

The last option would appear to be unacceptable to stakeholders, given that it is likely to increase risks to service levels, to water quality and to the environment. There is clear evidence that Scottish Water (in common with other water companies and many asset intensive businesses) should develop a better understanding of the performance, condition of and risks associated with their assets.

There is a risk that if capital maintenance can only be rebased every five or six years that a regulated company has less incentive to look at the longer term stewardship of its assets. Customers could reasonably expect an asset intensive business to keep a wary eye on the future consequences of its asset maintenance decisions. Having said that, and given where we are now, a six yearly rebasing may be a pragmatic option in the short to medium term.

The first option is likely to be most consistent with inter-generational equity but it is also likely to require a level of understanding of asset performance, condition and risk that goes beyond where Scottish Water currently is. Addressing the maintenance challenge will not be quick. Scottish Water must continue with its ambitious programme of work in this area. We recognise the importance of taking small steps towards what is, by any standard, a challenging goal.



It does appear to be clear that there will need to be higher levels of capital maintenance and asset replacement expenditure in the future.

Scottish Water should work with Scottish Government, the Quality Regulators and the Customer Forum to develop a consensus on the best way forward. The tramlines will help to ensure that, whatever approach is ultimately chosen, Scottish Water will face the same 'hard budget constraint' that companies operating in competitive markets experience. There are other key considerations in establishing the relative merits of these options. These may include:

- the governance arrangements around any provision;
- an effective incentive which ensures that maintenance activity is properly targeted and carried out efficiently; and
- ensuring broad price stability.



Scottish Water's asset maintenance plans will likely be critical to establishing and maintaining the trust of customers.

Developing the monitoring framework to measure the extent to which service levels are being maintained

As noted above, the current suite of customer service measures focuses on current and historic performance. Scottish Water has performed well in recent years and is now among the top performing water companies across a range of measures. It will remain important for customers that these year-on-year service performance measures are maintained and that like-for-like comparisons can be made.

Scottish Water's asset maintenance plans will likely be critical to establishing and maintaining the trust of customers. It may be appropriate for Scottish Water to report on progress in developing these plans, on lessons learned and the extent to which it is relying on these plans in planning its capital maintenance. This may be an area where Scottish Water should expect some degree of verification to be sought.

How will this approach benefit customers?

Our plans in this area are designed to build on the significant progress Scottish Water has made with enhancing the levels of service for customers. Customers will benefit if Scottish Water continues to develop its understanding of the performance, risks and condition of its assets. In our view, Scottish Water should be better placed to maintain and improve service levels given that this Strategic Review of Charges will clarify the accountability for the maintenance of service levels and empower Scottish Water to make the decisions about how much capital maintenance expenditure should be allowed for in price limits. As noted earlier, it will be for Scottish Water to establish trust with its customers and stakeholders that it is taking appropriate steps.

What will success look like?

This chapter has explained the issues that arise in the effective management of long life assets. There is more to be done to develop a full understanding of the assets and how they can be most effectively maintained. Success does not require either a sudden or a dramatic change – rather it requires demonstrable progress and prudent stewardship of customers' money.

A consensus amongst customers and stakeholders that Scottish Water is making steady progress towards a comprehensive, shared understanding of asset condition, risk and service maintenance plans would constitute success. The onus is on Scottish Water to develop that consensus. This may not be easy given the history of capital maintenance in the industry (the retail arms of water companies will, for example, have to be persuaded!).

Customers and stakeholders would also likely expect to see evidence that Scottish Water makes further progress in identifying lowest whole life cost solutions, which potentially span multiple regulatory periods given its greater freedom in its use of capital expenditure allowances.

Conclusion

The Scottish water industry faces a challenge to address appropriately capital maintenance both now and into the future. The Scottish water industry is not alone. Other industries in other jurisdictions face similar issues.

Our approach is to think big and to make changes to the current regulatory framework. We plan to empower Scottish Water and place a clear onus on it to build the trust of its customers and stakeholders in its approach to the maintenance of service levels both now and into the future. We stand ready to support Scottish Water as it takes the very many small steps that will be required for long-term success. Success will manifest itself in steady progress in understanding assets and more targeted maintenance. This will not be a quick fix. As the regulator, we have a clear responsibility to protect both current and future customers from unexpected price shocks. Scottish Water has a similar responsibility.



Shared understanding of asset condition, risk and service maintenance plans would constitute success.

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Ensuring financial sustainability

The long-term financial sustainability of Scottish Water is vital to protecting both current and future customers. Sudden changes in prices are not in the interests of customers just as any deterioration in the overall levels of service (discussed in the previous chapter) is not in the interests of customers. This Chapter sets out the steps that we are taking to ensure Scottish Water can maintain its financial strength both now and in the future. It also discusses changes to the regulatory framework to allow appropriate monitoring of financial performance.

Introduction

Scottish Water is a publicly-owned company. It is accountable through Scottish Ministers to the Scottish Parliament and to the people of Scotland for its financial and operational performance. It is also immediately accountable to its customers for the services that it provides and the value for money that it offers. It is funded through charges levied on households and businesses. It can also access debt finance within limits set by the Scottish Government.

The Water Industry Commission for Scotland has a statutory duty to promote the interests of customers. As such, the Commission has consistently and carefully considered the financial sustainability of Scottish Water. Customers would not want to face sudden changes in prices or any deterioration in the overall levels of service. This requires the Commission to:

- determine the level of funding that is consistent with the lowest reasonable overall cost of delivering the objectives and charging principles set for Scottish Water by the Scottish Ministers;
- allow for appropriate financial mechanisms and incentives that will help to ensure services are provided as efficiently as possible over the long term; and
- have in place a monitoring framework that provides assurance that Scottish Water's financial performance remains sustainable.



Average household bills are the second lowest in Britain – some 10% cheaper than the average in England and Wales.

Scottish Water's financial performance is strong. The regulatory framework has served Scottish customers well in the period since Scottish Water was formed, facilitating significant improvements in the levels of service, drinking water quality and environmental compliance. Levels of service now match those of the best performing companies south of the border. The average household bill in Scotland has increased only slightly in real terms since 2002 (it is now the second lowest in Britain, £38 cheaper than the average in England and Wales). This has been possible because Scottish Water has reduced its operating costs and unit capital expenditure by about 50% since it was established in 2002.

There is, however, no room for complacency. Looking forward, Scottish Water faces a number of new challenges, which will have to be met with the same resolution that it showed in improving its efficiency over the last 15 years. These include:

- the need to ensure service and risk levels are maintained over the long-term (as discussed in Chapter 6);
- the ongoing requirement for enhancement in drinking water quality and environmental performance; for example, for removing lead from the water supply system and improving bathing water standards;
- a number of emerging risks in areas such as flooding and network resilience;
- the need to consider the rural cost and service challenge with a view to achieving compliance with UN Sustainable Development Goal 6⁴⁴;
- higher customer expectations; for example, on response times, water pressure issues, taste and odour; and
- issues such as climate change, cyber security, the circular economy and carbon reduction.

Ensuring that Scottish Water is able to address these challenges in a financially sustainable way will require improvements to our regulatory approach. It will require more innovation (Chapter 5). It will require stronger accountability to customers (Chapter 4) and, as set out in Chapter 3, a strong focus on working with stakeholders to 'do the right thing'. In short, it will require Scottish Water to look 'beyond compliance'.

⁴⁴

The UN SDG6 relates to ensuring the availability and sustainable management of water and sanitation for all.

Our approach at the last Strategic Review of Charges

At the last review, we sought to empower Scottish Water to take full ownership of its decisions – both in its business planning and in its delivery of that plan for customers. We wanted to ensure that the company was fully accountable for how well it delivers for customers and the environment in the long term, as is the case for companies that are not subject to economic regulation. We did not want Scottish Water to ‘hide’ behind the regulator – to be able to suggest that it was unable to meet customers’ or the Quality Regulators’ reasonable expectations because of constraints placed on it by the economic regulator.



At the last review, we sought to empower Scottish Water to take full ownership of its decisions – both in its business planning and in its delivery of that plan for customers.

We recognised that Scottish Water would be likely to achieve better value for money for its customers if it had more financial flexibility. At the same time, we wanted to ensure that both current and future customers were protected from financial shocks. To achieve this we:

- introduced a range for Scottish Water’s allowed for level of financial strength by setting ‘financial tramlines’ consistent with the long-term sustainable financing of the industry;
- incorporated these ranges into the regulatory contract; and
- put in place arrangements to enable Scottish Water, in agreement with the Customer Forum, to adopt the most sustainable approach available.

The following sections look at these changes in more detail.

Financial Tramlines

The tramlines mechanism provides a transparent framework for understanding Scottish Water’s financial performance. The onus is on Scottish Water to operate within this financial flexibility and, if necessary, take the appropriate action if financial performance moves towards the bottom end of the allowed for range.

This mechanism protects both Scottish Water and its customers in the short-run and over the longer term. Scottish Water is able to maintain its financial strength and is protected from unexpected shocks through the financial ‘buffer’ of the allowable ranges. If Scottish Water is able to deliver services more cost effectively, the savings are readily identified as out-performance and can be redirected to other priorities.

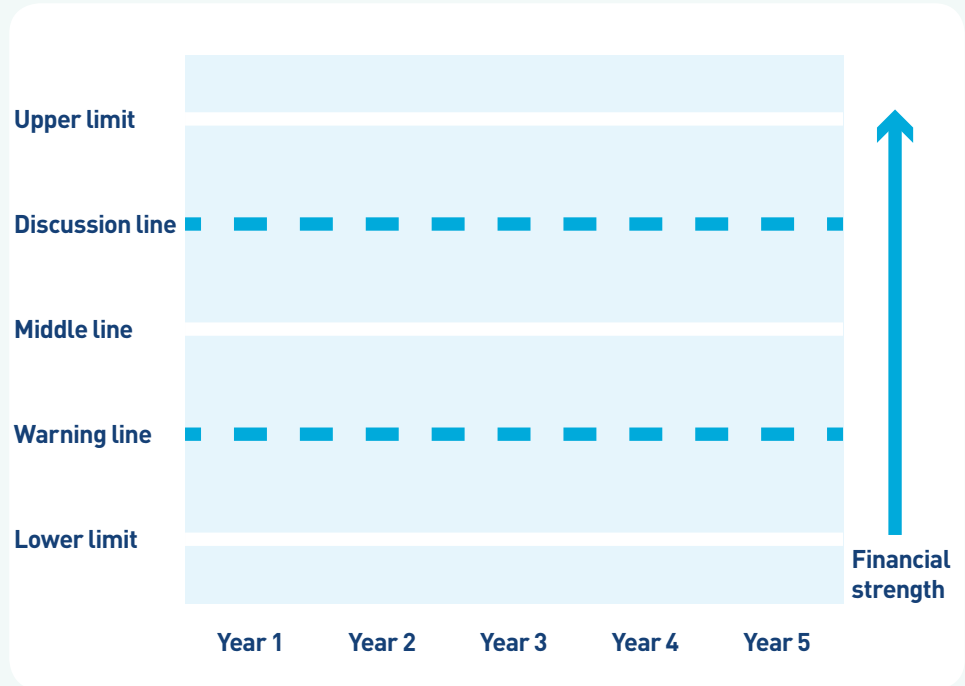
If Scottish Water reports financial performance at a level above the discussion line (See Figure 4) and it forecasts that its performance will remain above this level for the remainder of the regulatory control period, we would expect Scottish Water (in pursuit of building the trust of its customers and stakeholders) to begin discussions with the Scottish Government and the Customer Forum about how the outperformance should be used.

If Scottish Water’s performance were to fall short of expectations, we would expect that Scottish Water would want to explain how and when performance will improve in its next Delivery Plan.

Figure 4: Financial Tramlines



We would expect that Scottish Water would want to explain how and when performance will improve.



At the time of the Final Determination for the 2015-21 period, we set charges in an expectation that Scottish Water would begin and should exit the price control period broadly on the middle line.

This approach was designed to provide greater transparency and certainty to all the stakeholders involved. In particular, we wanted to:

- strengthen the incentive for Scottish Water to outperform – if the company, rather than the price review, delivers extra benefits for customers, then its reputation will be enhanced;
- allow customers to share any significant outperformance more quickly, rather than having to wait until the next time prices are set; and
- provide greater certainty on the financial resources that will be available to Scottish Water – allowing for better long-term planning.

In our Final Determination for the regulatory control period 2015-21⁴⁵, the financial tramlines were set around three cash-based financial ratios – ‘adjusted cash interest cover’, ‘funds from operations to debt’ and ‘gearing’. These ratios are commonly used by the credit rating agencies as indicators of financial health and are calculated on an International Financial Reporting Standards (IFRS) basis.



Increased financial flexibility was intended to promote lower cost and move innovative solutions.

Building these changes into the regulatory contract

The Strategic Review of Charges 2015-21 – and the associated business plan agreed with the Customer Forum – established performance against the financial tramlines as a key element of the regulatory contract for the 2015-21 period. As part of its yearly Delivery Plan and Annual Return submissions, Scottish Water provides an update on its performance against the tramlines, explaining the cause of any variation.

This reconciliation could highlight, for example, changes in the level of Government borrowing made available, or the profile of capital expenditure. It could also be expected to identify the scope for utilising any out-performance, taking account of any provisions required for agreed additional outputs; for example, the work to improve the resilience of the Ayrshire network.

Our annual performance report highlights progress against the financial tramlines and, where required, will provide commentary on Scottish Water's assessment of its performance.

Ensuring best value for money solutions

The increased financial flexibility was intended to help remove any bias towards capital expenditure and promote lower cost and more innovative solutions. Our financial performance monitoring is on the basis of cash flow and, as such, it avoids arbitrary splits between capital and operating expenditure. This should remove any potential (economic regulatory) barrier to Scottish Water identifying the lowest whole-life cost solutions.

What worked well?

The financial tramlines, with their focus on key financial ratios, represented a significant change to the previous regulatory framework. The concept has been readily accepted. It has allowed monitoring of factors within and outside the control of Scottish Water. For example, it has proved to be relatively straightforward to make the adjustments to reflect the impact of Government decisions on annual borrowing levels.

The tramlines were designed to allow Scottish Water flexibility in their management of their resources but, at the same time, to ensure that the regulatory discipline of a 'hard budget constraint' was maintained. Scottish Water's performance so far in this regulatory period suggests that the tramlines are broadly functioning in the way that was intended. The mechanism has successfully identified the extent of out-performance during the first year, and is providing the increased level of transparency on financial performance that was sought. This is already proving useful. For example, we have an improved understanding of the resources that are currently available to Scottish Water as we head into the 2018 'Investment review'⁴⁶.

It is also evident that the introduction of the 'tramlines' has encouraged a greater degree of innovation, including closer joint working with stakeholders and a move away from a bias towards capital solutions. For example, it appears likely that trials currently underway will identify an operating solution for wastewater discharges into the Clyde that will result in significant savings over a conventional treatment facility. Similarly, joint study work with SEPA is helping facilitate catchment management solutions to address water quality issues and identifying cost-effective approaches to improving bathing waters and tackling flooding.

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The Investment Review process was introduced in the 2015-21 Strategic Review to allow a 3 year mid-point review of the investment outputs for delivery in the remainder of the period, and into subsequent periods, to address uncertainties associated with outputs that required further study or were not fully defined at the time of the business plan.

What should we do better?

We have learned that presenting the boundaries of the tramlines in terms of financial ratios is not ideal. It limits the accessibility of the information. We can take steps to present the same information in a more accessible way – for example, we could present the tramlines in terms of the adjusted cash balances that Scottish Water should have.

There are new challenges ahead. For example, we do not yet know what investment may be required at the end of the current waste water PFI projects. There will be potential savings in operating costs but there is likely to be a need to commit some resources to the maintenance of the returned assets.

In its commissioning letter for the next Strategic Review⁴⁷, the Scottish Government suggests that lower levels of borrowing will be available in the next regulatory control period. It is becoming increasingly clear that investment to improve drinking water and the environment are unlikely to decline much, if at all and, as such, it is not appropriate to borrow for these purposes. Depending on how borrowing allowances are phased, the expected reduction could place an upward pressure on prices in the short-run – but it will likely result in lower bills over the longer term.



We do not yet know what investment may be required at the end of the current waste water PFI projects.

What do we plan for the Strategic Review of Charges 2021-27?

We plan to build on the approaches developed in the previous Strategic Review of Charges. As explained above, there are small changes that we can make to the 'tramlines', which will further improve their effectiveness.

There could also be scope to improve the benefit sharing mechanism that we were keen to encourage. As discussed in Chapter 2, a key Board decision in a private company is the declaration of the dividend at the end of the financial year. It signals the confidence of the Board in the future performance of the company. In keeping with the expectation that Scottish Water should build the trust of its customers and stakeholders, we believe that the Scottish Water Board could consider bringing a similar degree of formality to its assessment of its performance.

We are also exploring with Scottish Water and the Scottish Government whether there could be a link between one-off investment needs (addressing flooding, growth etc.) and the borrowing that the Government can make available. We discussed our planned approach to maintaining service levels in the previous chapter.

⁴⁷
See Appendix 1

How will this approach benefit customers?

Scottish Water should be responsible to its customers both in terms of the value for money it provides and for its overall financial performance (given that customers are the ultimate owners of the business). Our approach should now allow this to happen. We believe that the Board of Scottish Water wants to take responsibility and evidence the improvements in its performance. The switch to cash indicators should also help the Scottish Water Board achieve this.

In our view, linking borrowing more directly to specific improvements will provide benefits by making it clear what we are all getting from the public expenditure that is being made available.

Moving away from 'pay the minimum that is demonstrably required' will doubtless be challenging, but, potentially, such a move could bring great benefits for customers, both in terms of price stability and in terms of the continuing reliability of the services that we all use.

What will success look like?

Success will be demonstrated in the approaches adopted by Scottish Water to build the trust of its customers and other stakeholders. This trust will likely be a function of the evidence that Scottish Water makes available and its willingness to be open and honest about things that do not go as well as was hoped. Prudent financial management and ensuring that service levels (asset performance, risks and condition) are maintained will likely be essential in establishing and maintaining trust. As the economic regulator, we will monitor carefully and, should it prove necessary, we will seek to verify that customers' interests are being served.

Conclusion

Scottish Water has transformed its financial performance in the 15 years since it was established. It is now in a strong financial position and the regulatory framework provides effective oversight of financial performance. There is, however, no room for complacency and we need to ensure that the regulatory framework continues to work effectively.

Our approach for the Strategic Review of Charges 2021-27 offers Scottish Water the opportunity to manage its business to meet the needs and expectations of its customers. To take full advantage of this flexibility, Scottish Water will have to seek trust from its customers and other stakeholders. It should provide clear evidence (that can be verified) that its approach is consistent with maintaining levels of service and value for money over both short and long-term horizons. In our view, this will likely require Scottish Water:

- to take the initiative in sharing the benefits of its performance;
- to demonstrate the value of the public expenditure used by the industry by making the results of the borrowing more tangible; and
- to take steps to move away from the 'pay the minimum that is demonstrably required' approach to capital maintenance.



Success will be demonstrated in the approaches adopted by Scottish Water to build the trust of its customers and other stakeholders.

This methodology builds substantially on the steps that we took at the last Strategic Review of Charges. It develops further those aspects that appear to be working well and seeks to address other areas where we can improve the regulatory framework. We stand ready to work with the Scottish Government, the Customer Forum, Scottish Water and other stakeholders to support Scottish Water in building the trust of its customers and stakeholders. Of course, we are also prepared to intervene if we believe the evidence provided by Scottish Water is incomplete or inaccurate. Our goal is to ensure that Scottish Water can continue to offer excellent value for money. The onus is now firmly placed on Scottish Water to deliver.

1

Appendix 1

Environment and Forestry Directorate

Water Industry Division

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Professor Gordon Hughes

Water Industry Commission for Scotland

First Floor

Moray House

Forthside Way

Stirling

FK8 1QZ



31 January 2017

Dear Gordon,

STRATEGIC REVIEW OF WATER CHARGES: 2021-27

The Water Industry (Scotland) Act 2002, as amended by the Water Services etc. (Scotland) Act 2005, places duties on both the Scottish Ministers (Ministers) and the Water Industry Commission (the Commission). In particular it requires Ministers to specify the time period for the Strategic Review of Charges (SRC) and the date by which a Determination must be made. In furtherance of these powers I am writing to inform you of the broad arrangements that Ministers wish to be followed in the next Strategic Review of Charges.

The Commission is to undertake a Strategic Review of Charges for the six-year period 2021 to 2027. The Final Determination of Charges should be published by the end of March 2020.

In conducting the Review, Ministers look to the Commission to work with Scottish Water, Consumer Advice Scotland and other regulators and stakeholders to build on the arrangements put in place successfully in previous regulatory periods. Those arrangements have developed and evolved over successive reviews. They have ensured stability and continuity in financing and investment planning and have created a framework within which Scottish Water has significantly improved levels of efficiency and service delivery. This has ensured that the water industry has made an essential contribution to the Government's purpose of increasing sustainable economic growth.

It will be important that these regulatory mechanisms continue to evolve. In particular Ministers invite the Commission to ensure the processes of the Review give customers an enhanced voice in the consideration of levels of charges and service priorities. Ministers also recognise that the coming regulatory period will present some important challenges to Scottish Water and accordingly invite the Commission to work with Scottish Water to ensure they are properly addressed. These include most significantly:

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Capital Maintenance – Over this and future regulatory periods, Scottish Water should continue the transition to a risk based approach to maintaining the overall condition and performance of the assets so as to ensure no deterioration of service levels to customers over the long term. Ministers recognise the increasing importance of capital maintenance in achieving and maintaining service levels and statutory obligations in relation to drinking water quality and the environment and to reflect customer priorities that may affect longer term asset planning. This requires to be efficiently planned and delivered within successive regulatory periods. They wish the Commission to ensure that there is a stable and sustainable funding regime for this important part of the investment programme.

Resilience – Ministers recognise the progress Scottish Water has made in developing a strategic approach to identifying the work required to ensure the resilience of the network and requests that the Commission provides assurance that Scottish Water’s approach is proportionate, fit for purpose over the long term and represents value for money for customers.

Strategic Capacity – Ministers wish to ensure that Scottish Water is properly financed and incentivised to provide water and sewerage assets in a manner that does not place a constraint or restriction on the achievement of their housing and economic development targets. To achieve this Ministers look to the Commission to ensure that finance is available to Scottish Water for this purpose over the regulatory period and that the funding arrangements for additional capacity (including the Reasonable Cost Contribution) remain fit for purpose and strike the correct balance of cost between existing customers, new customers and borrowing.

Private Finance Initiative funded Projects – Ministers recognise that 3 of the 9 PFI contracts mature in the period 2021-27. They have asked Scottish Water to consider the options and costs for the future operation and funding of these assets. They request that the Commission undertake a full examination of Scottish Water’s approach to establishing the options and costs.

Partnership Projects – Ministers recognise the progress that Scottish Water has made in delivering improvements in partnership with other stakeholders, and in particular Local Authorities. They consider that, increasingly, delivering outcomes particularly in relation to the reduction of flood risk and compliance with bathing water standards will require Scottish Water to work closely with Local Authorities and communities. Ministers therefore request that the Commission ensures that the funding arrangements are sufficiently flexible so that Scottish Water can deliver to agreed timetables.

Supporting innovation – Ministers look to Scottish Water to contribute to inclusive and sustainable economic growth to which end they are encouraged to be innovative in their operation and with regards to capital enhancement and maintenance. In addition, Scottish Water is expected to support the Hydro Nation programme through their renewable energy and energy efficiency programmes and by working with communities and customers in Scotland and, through SWI, overseas. Ministers therefore request that the Commission ensures that the financing and funding arrangements for Scottish Water’s regulated elements create appropriate incentives towards efficient delivery of these objectives.

Principles of Charging

Ministers recognise that their Principles of Charging for past regulatory periods have provided a framework which has secured significant stability and clarity for Scottish Water, its customers and stakeholders. Ministers will confirm the Principles of Charges to be applied by December 2019 following consultation.

Ministers expect that the Principles for the period 2021-27 will be broadly consistent with previous versions which may therefore be useful in guiding the initial stages of the review.

Ministers will consider the advice from the Long-Term charging group on the modernisation of water charges so as to ensure that these continue to deliver the principles of cost reflectivity and cost recovery. As in previous periods, the Principles of Charging will indicate the level of finance they are willing to make available in support of the investment programme. Their present expectation is that this will be lower than in previous periods.

Statement of Objectives

Ministers will present their draft objectives in April 2018 and finalise their objectives in December 2019.

Ministers expect that the objectives for the period 2021-27 will be broadly consistent with those set in 2014. They expect that the programme of outputs identified to achieve these objectives should reflect the best possible value for money in terms of the improvement in outcome achieved for the investment made. They will look to the Q&S4 Project Management Team, and the Output Monitoring Group, for advice on this matter and to develop the outputs necessary to secure this aim.

The current objectives recognise the importance of the security of Scottish Water's physical assets, the evolution of new threats to public services requires also that, relevant security standards in relation, IT systems and personnel, as advised by Scottish Government Resilient Essential Services, should be met.

Average annual expenditure on the investment programme should remain of a size that allows efficient delivery.

Ministers expect the Q&S4 Project Management Team, with advice from the Output Monitoring Group, to develop the outputs necessary to deliver these objectives. Consistent with Ministers' policy of continuity of investment, draft objectives for the subsequent period 2027-33 should also be developed. As for previous investment periods, these must demonstrate how they will contribute to the Government's purpose of increasing inclusive and sustainable economic growth. Scottish Water will also be required to continue to meet their statutory obligations to respond to future climate change making necessary climate change related adaptations to operational practice and assets and should ensure systematic monitoring of carbon emissions.

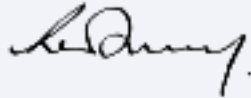
Timetable

In agreeing the timetable for this SRC, Ministers ask that all parties ensure that, in keeping with good practice, sufficient time is made available to ensure appropriate consultation with the wider stakeholder group, communication with customers and for the Government's own public engagement.

Ministers look forward to receiving regular reports on the progress of the strategic review.

I am copying this letter to the Chair of Scottish Water, the Chair of Scottish Environment Protection Agency, the Drinking Water Quality Regulator for Scotland, the Chair of Consumer Advice Scotland and the Chair of the Competition Commission.

Yours sincerely



Bob Irvine

Victoria Quay, Edinburgh EH6 6QQ
www.gov.scot



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Appendix 2

Appendix 2

CO-OPERATION AGREEMENT

among

THE WATER INDUSTRY COMMISSION FOR SCOTLAND, a body corporate established under section 1 of the Water Industry (Scotland) Act 2002 (the “2002 Act”) **and having its principal office at** First Floor, Moray House, Forthside Way, Stirling FK8 1QZ (the “Commission”)

SCOTTISH WATER, a body corporate established under section 20 of the 2002 Act and **having its head office at 6 Castle Drive, Dunfermline, Fife KY11 8GG** (“Scottish Water”); and

CITIZENS ADVICE SCOTLAND, the operating name of the Scottish Association of Citizens Advice Bureaux, a company limited by guarantee and a registered charity, and designated as a consumer advocacy body under section 1 of the Consumers, Estate Agents and Redress Act 2007 having its principal office at Spectrum House, 2 Powderhall Road, Edinburgh EH7 4GB (“CAS”), including its internal Consumer Futures Unit (“CFU”) and any reference to CAS shall include its CFU and vice versa.

Whereas

- (1) The Commission has the function under Part 3 of the 2002 Act of determining maximum amounts of charges for services provided by Scottish Water by such time and in respect of such period (the “Review Period”) as the Scottish Ministers may specify (the process by which the Commission discharges this function being known as the “Strategic Review of Charges” or “SRC”).
- (2) The Commission is required to exercise this function for the purpose of ensuring that (a) Scottish Water’s income from charges, taken together with certain other resources, is not less than sufficient to meet the expenditure it requires for the effective exercise of its core functions (which is taken to be the case where Scottish Water makes such use of its resources that it achieves the objectives set for it by the Scottish Ministers (the “Ministerial Objectives”) at the lowest reasonable overall cost); and (b) so far as is consistent with (a), any charges scheme made by Scottish Water gives effect to the statement of policy regarding charges issued by the Scottish Ministers in respect of the Review Period (the “Statement of Policy”).
- (3) The Scottish Ministers must, before setting the Ministerial Objectives or issuing the Statement of Policy, consult CAS. The Commission must, before determining maximum amounts of charges, invite representations on a draft of its determination from the Scottish Ministers, Scottish Water and CAS.
- (4) The CFU performs an important role in inputting to the Scottish Government’s “Quality and Standards” exercise which informs the setting of the Ministerial Objectives and will be conducting research (and coordinating with Scottish Water) in that context (such research being known as the “CFU Research”).
- (5) A customer forum was established further to a previous co-operation agreement between the Commission, Scottish Water and the National Consumer Council and supported the representation of customer views in the development of the Strategic Review of Charges in respect of the 2015 - 2021 Review Period (the “SRC 2015-21”).

- (6) The Commission is expecting to receive a letter from the Scottish Ministers requesting it to undertake a Strategic Review of Charges in respect of the 2021 - 2027 Review Period (the "SRC 2021-27") and to build upon the successful involvement of customers throughout the SRC 2015-21.
- (7) The Parties have held a series of discussions in light of the anticipated request from the Minister and have concluded, building on the lessons from the previous customer forum and having regard to the requirements of the 2002 Act, that they should establish a second customer forum to play a formal role in facilitating effective customer engagement and acting as a conduit for customer views in the context of the SRC 2021-27 (the "Forum").
- (8) The Commission proposes, in an iterative and progressively more focused process, to issue to the Forum a series of decisions (the "Commission Decisions") as to the range of issues and range of costs relevant to the determination of lowest reasonable overall cost and establishing a framework within which the customer engagement described above should take place.
- (9) The Parties envisage that the Forum will seek to agree with Scottish Water a business plan for delivery by Scottish Water in 2021-27 which is fully consistent with the Ministerial Objectives, the Statement of Policy and the Commission Decisions (a business plan agreed on such a basis being known as an "Agreed Business Plan").
- (10) The Commission is minded (subject to the provisions of this Agreement) that the draft determination made by it in respect of the 2021 - 2027 Review Period should reflect fully and completely the terms of a draft business plan agreed by the Forum and Scottish Water which would (if adopted) amount to an Agreed Business Plan (a "Draft Agreed Business Plan").
- (11) Assuming that the draft determination made by the Commission is made in the circumstances contemplated above, the Parties envisage that, following the receipt of representations on the draft determination, the Forum and Scottish Water will review the Draft Agreed Business Plan in light of such further Commission Decision(s) issued to the Forum in light of those representations.
- (12) The Commission is minded (subject to the provisions of this Agreement) that the final determination made by it in respect of the 2021 - 2027 Review Period should reflect fully and completely the terms of a business plan agreed by the Forum and Scottish Water in light of the review mentioned above and amounting to an Agreed Business Plan.

Now it is agreed as follows

1. Definitions and interpretation

- 1.1 Words and expressions defined in the 2002 Act shall, unless otherwise provided, have the same meaning when used in this Agreement.
- 1.2 The capitalised words and expressions shown in column 1 below shall have the meaning shown in column 2 below.

Column 1	Column 2
Agreed Business Plan	has the meaning ascribed to it by recital (9) of the preamble to this Agreement.
Business Plan Agreement Committee or Committee	has the meaning ascribed to it by clause 4.1 of this Agreement.
CFU Research	has the meaning ascribed to it by recital (4) of the preamble to this Agreement.
Commission Decisions	has the meaning ascribed to it by recital (8) of the preamble to this Agreement (and "Commission Decision" shall be construed accordingly); a non-exhaustive list of proposed Commission Decisions is set out in part 1 of the Schedule to this Agreement.
Draft Agreed Business Plan	has the meaning ascribed to it by recital (10) of the preamble to this Agreement.
Financial Year	a financial year of the Commission.
Forum	has the meaning ascribed to it by recital (7) of the preamble to this Agreement.
Ministerial Objectives	has the meaning ascribed to it by recital (2) of the preamble to this Agreement.
Parties	the Commission, Scottish Water and CAS.
Review Period	has the meaning ascribed to it by recital (1) of the preamble to this Agreement.
Statement of Policy	has the meaning ascribed to it by recital (2) of the preamble to this Agreement.
Strategic Review of Charges or SRC	has the meaning ascribed to it by recital (1) of the preamble to this Agreement.
SRC 2015-21	has the meaning ascribed to it by recital (5) of the preamble to this Agreement.
SRC 2021-27	has the meaning ascribed to it by recital (6) of the preamble to this Agreement.
SRC 2021-27 Completion Date	means the date which is the later of (i) expiry of the period during which Scottish Water may request the Commission to make a reference to the Competition and Markets Authority in respect of the determination made by it at the conclusion of the SRC 2021-27 process; and (ii) in the event that such a request is made, the date upon which the Competition and Markets Authority reports to the Commission on the reference made by it.
SRC Research Programme	has the meaning ascribed to it by clause 2.1.1 of this Agreement.

2. Aims and principles

- 2.1 Subject to the remaining provisions of this clause 2, the purpose of the Forum is to play a key role in the SRC 2021-27 process by:
 - 2.1.1 working with Scottish Water (subject to clause 6.1) on a programme of high quality, behavioural, quantitative and qualitative research within the context of the SRC to establish customers' priorities for service level improvement and expectations in terms of the level of charges (the "SRC Research Programme");
 - 2.1.2 ensuring that the SRC Research Programme includes a meaningful level of engagement from communities (in both a geographic sense and in the sense of persons sharing particular interests);
 - 2.1.3 understanding and representing to the Commission and to Scottish Water the priorities and preferences of customers (as a whole) in the SRC 2021-27 process as identified through the SRC Research Programme; and
 - 2.1.4 seeking to secure, through its participation in the SRC 2021-27 process, the most appropriate outcome for customers (as a whole, both now and into the future) based on those priorities and preferences, in particular by seeking to establish an Agreed Business Plan;in a manner consistent with the provisions of this Agreement.
- 2.2 Scottish Water, the Forum and CAS will put in place operational arrangements to ensure effective co-ordination of their research programmes in the context of the SRC 2021-27 process.
- 2.3 Following such consultation with Scottish Water, CAS and the Scottish Ministers as it considers appropriate, the Commission shall provide the Forum with a letter (which may be amended or supplemented from time to time), such letter (as amended or supplemented) being referred to as the "Commissioning Letter") dealing with (i) the process and timescale envisaged in relation to the SRC 2021-27, (ii) the arrangements to be made for dialogue between the Commission and the Forum in the context of the SRC 2021-27 and (iii) the steps to be taken by the Commission in assessing whether a business plan (or Draft Agreed Business plan (if adopted)) would represent an Agreed Business Plan and the Forum will perform its role in line with that Commissioning Letter.
- 2.4 The Forum may undertake such activities as it considers (having regard to the need to keep within its agreed budget) to be necessary or desirable in order to perform its role under this agreement and shall, where appropriate, consult with Scottish Water and the industry quality regulators, SEPA and DWQR, as to such matters as:
 - 2.4.1 in the context of the SRC 2015-21, what Scottish Water has done to deliver the business plan agreed between the previous customer forum and Scottish Water; and
 - 2.4.2 in the context of the SRC 2021-27, how Scottish Water has decided what needs to be done in order to meet the Ministerial Objectives and the associated costs of this activity and also to any customer priorities and preferences for expenditure beyond that which is required to meet those objectives (and any associated cost challenge); andthe Forum may request information from the Commission for the purposes of such activities and may provide comments to the Commission on information received.
- 2.5 The members of the Forum will be accountable to the Parties for ensuring that they act at all times in a manner consistent with the aims and principles set out above and otherwise in accordance with this Agreement.

- 2.6 The Parties undertake to do all such things as may be necessary or desirable for the purpose of giving effect to this Agreement and shall cooperate in good faith with each other and with the representatives of the Forum with a view to securing the aims and principles set out above.

3. Constitution and governance

- 3.1 The Forum is not intended to be constituted as a separate legal entity and will consist of a panel of nine Ordinary Members and a Chair each of whom will be appointed jointly by the Parties.
- 3.2 The procedure and terms governing the appointment of members is set out in Part 2 of the Schedule. The members of the Forum will be selected in line with appropriate recruitment provisions and with due consideration to the principles of diversity and equality of opportunity, as outlined at Part 2 of the Schedule
- 3.3 The members of the Forum will be required to act within the terms of clause 2. The Forum will have discretion as to how to frame the discussions between the Business Plan Agreement Committee, as outlined at clause 4 below, and Scottish Water but with reference to the views and opinions obtained from the public generally in consumer research. It is not expected to be involved in policy decisions nor is it intended to be a voice for the community generally in relation to matters outwith the purpose outlined in clause 2. The Parties will ensure that all members are fully aware of the time commitments required of Forum membership.
- 3.4 While respecting the Forum's independence:
- 3.4.1 the Forum will provide quarterly reports (i) to the Parties on its activities over the relevant period and (ii) to the Commission and the CFU on its current view on progress towards the agreement of an Agreed Business Plan within the timescale envisaged by the Commissioning Letter;
- 3.4.2 there will be an annual meeting between the Forum, CAS and the Commission; and
- 3.4.3 the Commission and the CFU will also meet the Chair and (if appointed) Vice Chair of the Forum every six months.
- 3.5 The accountable body for the Forum is the Commission. The operational activities of the Forum must be consistent with the governance and remit of the Commission as the accountable body. This will not detract from the Forum's independent role with regard to the SRC 2021-27 process. In particular, the Forum will not have power to acquire or lease any property, borrow any sums, engage any employee or enter into any legally binding contracts or other arrangements, or undertake any other operational activity that is not consistent with the Commission's administrative policies or procedures. The Forum will provide quarterly reports on expenditure to the Commission.
- 3.6 Resources will be provided to the Forum by the Parties, as set out in clause 5.
- 3.7 If, notwithstanding the research programme described at clause 2.1.1 above, the Forum determines that additional research is required, the Forum may carry out such additional research and the costs of such research shall (unless otherwise agreed by the Parties) be paid from, and within the parameters of, the previously agreed Forum Budget.
- 3.8 No member of the Forum shall incur any third party expenses without having a prior, written delegation from the Chair. All such approved third party expenses shall be subject to the Commission's finance and procurement rules and reimbursed from the Forum Budget administered by the Commission. No member of the Forum shall be entitled to be reimbursed any third party expenses which have not had the prior approval of the Chair or which would exceed the balance of funds within the Forum Budget.

4. Business Plan Agreement Committee

- 4.1 The Forum will form a committee of its members to undertake the role of engaging directly with Scottish Water as regards the establishment of an Agreed Business Plan (the “Business Plan Agreement Committee” or “Committee”). The Committee will be established and will operate in accordance with the provisions of Part 3 of the Schedule.
- 4.2 After considering and discussing the customer research and the scope of the matters set out in clause 3 and the Commissioning Letter, together with the Commission Decisions, the Forum will provide the Committee with an initial remit for the engagement with Scottish Water. The Forum may amend or expand the remit at any time. In addition, the Forum may give specific directions to the Committee, which must be included in the package agreed with Scottish Water.
- 4.3 If the Committee agrees a position with Scottish Water, which is within the remit given to the Committee by the Forum, then the Forum will automatically approve the agreed position.
- 4.4 If the Committee is unable to agree a position that falls within the remit given to it by the Forum, it must go back to the Forum for approval. If the Forum agrees a position then the Committee must adopt that position in its discussions with Scottish Water.
- 4.5 If agreement is reached with Scottish Water, the Forum and Scottish Water will prepare a joint report to the Commission setting out the agreed terms.
- 4.6 If agreement cannot be reached with Scottish Water, the Forum and Scottish Water will endeavour to submit a joint report to the Commission setting out the points in issue and reasons for the disagreement, failing which the Forum and Scottish Water shall be required to submit separate reports to the Commission setting out their view of the points in issue and the reasons for disagreement.

5. Resources

- 5.1 The Parties agree that they shall meet the financial liabilities of the Forum and provide additional resources to the Forum as follows:
 - 5.1.1 The Commission shall provide the Forum with:
 - (i) a budget of £250,000 for Financial Year 2017-18, £250,000 for Financial Year 2018-19, £375,000 for Financial Year 2019-20 and £250,000 for Financial Year 2020-21 to meet the expenses of the Forum (the “Forum Budget”) to allocated and paid out of the Commission’s agreed annual levy, provided that the Commission and Forum may (without increasing the aggregate amount payable) agree on a different annual budget profile to that set out above; and
 - (ii) technical assistance, upon request by the Forum, including any resources necessary to analyse information provided by Scottish Water.
 - 5.1.2 The Commission shall:
 - (i) provide the Forum with payroll and other banking and accounting functions (including, without limitation, the preparation of monthly management accounts and audited annual accounts);
 - (ii) ensure that such Forum Budget is managed in accordance with the principles of regularity, propriety and value for money observed by the Commission in respect of its own affairs;
 - (iii) provide corporate services support in terms of facilities management, information technology (IT), human resources (HR) and senior management;
 - (iv) act as a contracting entity for any external resources that the Forum may have

to engage such as consultancy services and customer research; and

- (v) provide office accommodation, access to meeting room facilities and general administrative support services.

5.1.3 Scottish Water shall:

- (i) provide the Forum with access to all existing and ongoing customer research required for the purpose described at clause 2.1 above;

and both Scottish Water and CAS shall provide the Forum with:

- (ii) technical assistance upon request by the Forum; and
- (iii) meeting rooms on request by the Forum, at no additional cost to the Forum.

- 5.2 For the avoidance of doubt, direct costs incurred by the Forum shall be covered by the Forum Budget and will include staff costs, programme costs and running costs.
- 5.3 On termination of this Agreement and the disbanding of the Forum, the balance of the Forum Budget remaining after payment of all liabilities properly incurred by the Forum, if any, shall be retained by the Commission.
- 5.4 Other than the Forum Budget to be contributed annually by the Commission, the Parties shall have no obligation to contribute to the costs or liabilities of the Forum. The liability of the Parties to the members of the Forum shall be limited to the funds representing the balance of the Forum Budget held by the Commission.

6. OECD peer review and advisory input

- 6.1 The Parties agree that (i) there shall be an independent review by the OECD of the activities of the Forum and (ii) the OECD shall also provide the Forum and the Parties with advisory input on the behavioural research to be carried out pursuant to clause 2.1.1 and shall co-operate with the Commission to specify such further details of that review and input as may be required.
- 6.2 The Parties note that, in order to provide sufficient funds within the Forum Budget needed to cover the activities described above, the Commission may reduce repayments which would otherwise have been made to Scottish Water in respect of annual levy income.

7. Review of terms

- 7.1 The Parties agree to review the terms of this Agreement as soon as practicable following the SRC 2021-27 Completion Date. In addition, the Parties agree to review this Agreement in good time before any Party for any reason ceases to exist in order to ensure the continued operation of the Forum.

8. Termination and transfer

- 8.1 ***Subject to clauses 8.2 and 8.3, the Forum shall remain in place for at least such period as is required to facilitate effective customer engagement in the context of the SRC 2021-27 process and to complete any further role assigned to it by the Parties under this agreement. Thereafter the Parties may disband the Forum and may terminate this Agreement, other than clauses 2.6, 5.2, 5.3, 13, 14 and 15 which shall survive such termination.***
- 8.2 The Parties shall co-operate to ensure that the activities of the Forum are effectively wound down. This shall include, but not be limited to, ensuring that all information, analysis and any records generated or held by the Forum are retained and accessible to the Parties and that any reviews of the work of the Forum can be completed effectively.

- 8.3 In the event a statutory body is established which is considered suitable for the purpose of assuming the functions of the Forum under this Agreement, the Parties shall co-operate to ensure the orderly transfer of those functions to that body, the winding down of the Forum and the termination of this Agreement.

9. Announcements

- 9.1 Save as otherwise set out in this Agreement, no announcement, circular, advertisement or other publicity in connection with this Agreement, its subject matter or any ancillary matter shall be made or issued by or on behalf of any Party (save as required by law or any governmental or regulatory organisation) without the prior written consent of the other Parties (such consent not to be unreasonably withheld or delayed).

10. Notices

- 10.1 Any notice, demand or communication in connection with this Agreement shall be in writing and delivered personally or sent by pre-paid first class post (or airmail if overseas) or by fax to the recipient's address as set out at the beginning of this Agreement or to any other address which the recipient has notified in writing to the sender not less than 7 days before the notice is despatched.

- 10.2 The notice, demand or communication is deemed given:

- 10.2.1 if delivered personally, at the time of delivery to the address provided for in this Agreement; or
- 10.2.2 if sent by pre-paid first class post, on the second business day after posting it; or provided that, if it is delivered personally or sent by fax on a day which is not a business day or after 4pm on any business day, it shall instead be deemed to have been given or made on the next business day.

11. Entire agreement

- 11.1 This Agreement and the documents referred to in it, constitute the entire agreement between the Parties and supersede and replace any previous agreement, understanding, undertaking or arrangement of any nature between the Parties relating to the subject matter of this Agreement, save that nothing in this Agreement shall limit or exclude any liability for fraud.

12. Variation

- 12.1 Subject to clause 12.2, this Agreement may only be varied by an agreement in writing signed by or on behalf of each party to this Agreement.
- 12.2 If a Party ceases to exist the consent of that Party shall not be required for any variation of this Agreement.

13. Legal effect

- 13.1 Nothing contained in this Agreement, and no action taken by the Parties pursuant to this Agreement, shall be deemed to constitute a relationship between the Parties of partnership, joint venture, principal and agent or employer and employee. None of the Parties has, nor may it represent that it has, any authority to act or make any commitments on the other Parties' behalf or otherwise bind the other Parties in any way.
- 13.2 ***Nothing in this Agreement shall be construed as limiting or restricting the ability of any of the Parties to exercise any powers or functions conferred on it by or under any enactment, or to perform any duty (including a duty to exercise discretion) imposed on it in relation to any such power or function.***

14. Governing law

14.1 The formation, existence, construction, performance, validity and all aspects whatsoever of this Agreement or any term of it (including non-contractual disputes or claims) shall be governed by the laws of Scotland.

15. Dispute resolution

15.1 In the event of any dispute arising out of or in relation to this Agreement, each of the Parties shall use all reasonable endeavours to consult and negotiate with each other, in good faith and, recognising their mutual interests, attempt to reach a settlement of the dispute to the satisfaction of all Parties. Within 7 days of a dispute arising the Parties shall convene a meeting between persons nominated by each Party (the "Appointed Persons") to attempt to resolve the dispute.

15.2 If the Appointed Persons agree upon a resolution of the dispute, they shall sign a statement setting out the terms of the resolution and the Parties shall use procure that the resolution is fully and promptly carried out.

IN WITNESS WHEREOF these presents consisting of this and the 7 preceding pages and the Schedule consisting of 3 parts have been subscribed as follows:

EXECUTED for and on behalf of **THE WATER
INDUSTRY COMMISSION FOR SCOTLAND**

at

on

by

its authorised signatory in the presence
of this witness:

Witness

Full name

Address

.....

Authorised signatory

EXECUTED for and on behalf of
SCOTTISH WATER

at

on

by

its authorised signatory in the presence
of this witness:

Witness

Full name

Address

.....

Authorised signatory

EXECUTED for and on behalf of
CITIZENS ADVICE SCOTLAND

at

on

by

its authorised signatory in the presence
of this witness:

.....

Witness

Authorised signatory

Full name

Address

.....

This is the Schedule, consisting of three parts, referred to in the foregoing Co-operation Agreement among The Water Industry Commission for Scotland, Scottish Water and Citizens Advice Scotland.

Schedule Part 1

Non-exhaustive list of proposed Commission Decisions

The following table sets out the proposed Commission Decisions to be issued by the Commission which, together with such other Commission Decisions as the Commission may issue from time to time, will inform the discussions between the Customer Forum and Scottish Water in establishing an Agreed Business Plan.

[Note: this schedule is now superseded by the information provided in Appendix 4 of this document]

When	Description
May 2017	<p>The Commission issues Decision Paper 1</p> <p>This paper would cover:</p> <ul style="list-style-type: none"> Initial views on the inflation, interest rates and other macro-economic assumptions. Initial views on the customer base and growth assumptions. Initial views on the initial range for the investment requirements to meet growth.
July 2017	<p>The Commission issues Decision Paper 2</p> <p>This paper would cover:</p> <ul style="list-style-type: none"> Initial views on operating expenditure. Initial levels of service ranges. Initial views on resilience and its investment implications.
Oct 2017	<p>The Commission issues Decision Paper 3</p> <p>This paper would cover:</p> <ul style="list-style-type: none"> Initial views on operating efficiency. Initial views on capital efficiency. Our initial approach to encourage innovation.
Dec 2017	<p>The Commission issues Decision Paper 4</p> <p>This paper would cover:</p> <ul style="list-style-type: none"> Initial views on financial strategy. Initial views on the capital enhancement ranges. Initial views on the capital maintenance ranges. Initial views on evolving the financial tramlines.
End Dec 2017	<p>The Commission has published its initial decisions on the key regulatory parameters which constitute the lowest reasonable overall cost of meeting ministerial objectives.</p>
June 2018	<p>The Commission issues Decision Paper 5</p> <p>This paper would take account of SW's 25 year strategic projections and any new information and would cover:</p> <ul style="list-style-type: none"> Revised inflation, interest rates and other macro-economic assumptions. Revised customer base and growth assumptions. Revised ranges for the investment requirements to meet growth.

When	Description
Aug 2018	<p>The Commission issues Decision Paper 6</p> <p>This paper would take account of SW's 25 year strategic projections and any new information and would cover:</p> <ul style="list-style-type: none"> Revised ranges on operating expenditure. Revised levels of service ranges. Revised views on resilience and its investment implications.
Oct 2018	<p>The Commission issues Decision Paper 7</p> <p>This paper would take account of SW's 25 year strategic projections and any new information and would cover:</p> <ul style="list-style-type: none"> Updated views on financial strategy. Revised views on the capital enhancement ranges. Revised views on the capital maintenance ranges.
Dec 2018	<p>The Commission issues Decision Paper 8</p> <p>This paper would take account of SW's 25 year strategic projections and any new information and would cover:</p> <ul style="list-style-type: none"> Revised views on operating efficiency. Revised views on capital efficiency. Revised approach to encouraging innovation.
End Dec 2018	<p>The Commission has published its revised decisions on the key regulatory parameters which constitute the lowest reasonable overall cost of meeting ministerial objectives.</p>
July 2019	<p>The Commission issues Decision Paper 9</p> <p>This final paper takes account of information set out in SW's draft business plan for 2021-27 and sets out the Commission's final decisions on all the above key regulatory parameters.</p>

Schedule Part 2

Constitution of Forum

1. Appointment of Chair and members

- 1.1 Subject to paragraph 1.12 below, members will be appointed jointly by Scottish Water, the Commission and CFU, but on the basis of the following nominations procedure:
 - 1.1.1 Scottish Water, CFU and the Commission shall jointly nominate an independent Chair;
 - 1.1.2 the Chair, in consultation with CFU and the Commission, shall nominate as Ordinary Members up to three persons who previously served on the customer forum established for the SRC 2015-21 (whether as a result of nomination by water services providers and/or sewerage services providers (the "Retailers") (a "Previous Retailer Member") or otherwise (a "Previous Other Member"));
 - 1.1.3 CFU shall seek nominations for such number of other Ordinary Members (as shall equal six minus the number of Previous Other Members nominated under paragraph 1.1.2) through posts publicly advertised through an appropriately open recruitment procedure (and CFU shall arrange for the Chair to participate in the interviews conducted as part of that procedure), and
 - 1.1.4 the Commission shall seek nominations for such number of other Ordinary Members nominated by the Retailers through an appropriately open recruitment procedure as shall equal three minus the number of Previous Retailer Members nominated under paragraph 1.1.2.
- 1.2 The persons nominated shall be appointed by the Parties, and there shall be no ability for any Party to veto the appointment of any person so nominated provided that such persons fulfil the criteria set out at paragraph 1.4 below. The Members shall hold office in their personal capacities and not as a representative of the person(s) who nominated them or any other person or body.
- 1.3 In developing any recruitment procedure, the Parties shall ensure that such process gives due consideration to the principles of diversity and equality of opportunity.
- 1.4 The Chair and Members must satisfy the following criteria:
 - 1.4.1 they must not hold a political office or be standing as a political candidate for election at any level;
 - 1.4.2 they must not have any criminal convictions;
 - 1.4.3 they must not have been disqualified from acting as a director;
 - 1.4.4 they must be prepared to engage constructively in the process outlined in clause 2 of the Agreement in a personal capacity without representing any political, local, community or specific interests; and
 - 1.4.5 they must not be an employee of, or have any commercial relationship with, Scottish Water, CAS or the Commission (and must have disclosed in writing to the other members of the Forum any former such role performed during the previous five years).
- 1.5 The Chair shall also be the Chair of the Business Plan Agreement Committee.
- 1.6 The Chair shall appoint a Vice Chair from the other members of the Forum. The Chair may determine what role(s) should be performed by the Vice Chair, but the Chair may not delegate to the Vice Chair any function expressly allocated to the Chair by this Agreement.

- 1.7 If a Chair is appointed who is already an existing Ordinary Member, they shall vacate that existing position and the entity, which originally nominated him to be an Ordinary Member pursuant to paragraph 1.4 above shall be entitled to nominate someone else in his place as an Ordinary Member.
- 1.8 The Ordinary Members and the Chair shall be appointed for such period as is required to complete the roles assigned to the Forum under this Agreement.
- 1.9 The Chair may conduct an annual appraisal of each of the other Members' performance in respect of their Forum duties and may share the results of those appraisals with the Parties.
- 1.10 Notwithstanding paragraph 1.4 above:
 - 1.10.1 the appointment of the Chair and each Ordinary Member will automatically terminate:
 - (i) if the Agreement is terminated; or
 - (ii) if a separate legal entity is established to take on the role of the Forum;
 - 1.10.2 the appointment of the Chair may be terminated by a unanimous decision of the Parties on the grounds of:
 - (i) misconduct;
 - (ii) being incapable over a period of twelve weeks or more of discharging their responsibilities and duties as Chair due to illness or other cause;
 - (iii) insolvency; or
 - (iv) failure to fulfil the criteria set out in paragraph 1.4 above;and Scottish Water, CFU and the Commission shall jointly nominate another Chair in his or her place;
 - 1.10.3 the appointment of an Ordinary Member nominated by the CFU may be terminated at the discretion of the Commission and CFU on the recommendation of the Chair on the grounds of:
 - (i) misconduct;
 - (ii) being incapable over a period of four weeks or more of discharging their responsibilities and duties as an Ordinary Member and/or member of the Business Plan Agreement Committee (as the case may be) due to illness or other cause;
 - (iii) insolvency; or
 - (iv) failure to fulfil the criteria set out in paragraph 1.4 above;and CFU shall be entitled to nominate another Ordinary Member in their place; and
 - 1.10.4 the appointment of an Ordinary Member (other than one nominated by the CFU) may be terminated at the discretion of the Commission on the recommendation of the Chair on the grounds of:
 - (i) misconduct;
 - (ii) being incapable over a period of four weeks or more of discharging their responsibilities and duties as an Ordinary Member and/or member of the Business Plan Agreement Committee (as the case may be) due to illness or other cause;

(iii) insolvency; or

(iv) failure to fulfil the criteria set out in paragraph 1.4 above;

and the party responsible for the original nomination of the Ordinary Member concerned shall be entitled to nominate another Ordinary Member in their place.

1.11 If the Chair resigns a new Chair will be appointed pursuant to paragraph 1.1.1 and paragraph 1.4 above.

1.12 If an Ordinary Member resigns a new Member will be appointed by the entity which originally nominated the person to be an Ordinary Member (or, in the case of the resignation of an Ordinary Member nominated by the Chairman, by the CFU) pursuant to paragraph 1.1.3 or 1.1.4 (as the case may be) and 1.4 above.

2. Remuneration

2.1 The Chair shall:

2.1.1 be paid an annual sum calculated on the basis of a commitment of up to 100 days per Financial Year at an daily rate equal to that payable from time to time to the Chair of the Commission minus ten percent; and

2.1.2 be entitled to reimbursement of properly incurred expenses in line with the Commission's travel and expenses policy (or any policy that the Commission creates for this purpose) upon submission of the relevant receipts to the Commission.

2.2 Ordinary Members that are not employees of, board members of, or otherwise related to, or engaged by CAS, or the Retailers shall:

2.2.1 be paid an annual sum calculated on the basis of a commitment of up to 50 days per Financial Year at a daily rate equal to that payable from time to time to a member of the Commission minus ten percent; and

2.2.2 be entitled to reimbursement of properly incurred expenses, which have been approved in advance by the Chair, in line with the Commission travel and expenses policy upon submission of the relevant receipts to the Commission.

3. Meetings

3.1 The Forum shall be entitled to decide how to regulate its affairs, including participating in meetings by telephone or video conference, but will be required to meet in person not less than once every quarter.

3.2 On request, CFU, Scottish Water and/or the Commission will make available an appropriate meeting room for the Forum meetings.

3.3 Unless otherwise agreed by all members of the Forum all members must be given not less than 14 days' notice of any meeting and the notice must include details of the business to be discussed at that meeting.

3.4 All members of the Forum will be entitled to receive copies of the minutes of each meeting and the papers tabled at each meeting.

3.5 Any matter which could be determined at a meeting of the Forum, may be validly determined if approval of the matter is given in writing (including by email or other form of electronic communication) by the percentage of members that would have been required to approve the matter had it been determined at a meeting.

3.6 Members of the Forum will be required to keep any information which they obtain or receive as a result of their participation in the Forum and (save as provided for in paragraphs 3.7 and 3.8) the content of all minutes and all such other papers together with the terms of the remit given to the Business Plan Agreement Committee and the discussions leading to the

agreement of that remit, confidential and will not be entitled to pass any such information to the person who appointed them without prior approval of the Chair. A breach of this restriction will entitle the defaulter to be removed from the Forum.

- 3.7 Subject to paragraph 3.8, the Chair will ensure that copies of all minutes and any associated papers shall be delivered to each of the Parties to enable them to be published on their respective websites not later than 3 months after the date of such minutes.
- 3.8 The obligation to deliver copies of minutes and associated papers within three months of the date of the relevant minutes shall not apply during the period in which the Business Plan Agreement Committee is in active engagement with Scottish Water and all minutes and papers relating to that period shall instead be delivered to the Parties as soon as reasonably practicable after **the SRC 2021-27 Completion Date**.

4. Quorum

The quorum for meetings of the Forum shall be six (unless fewer than six members have been appointed in which case all of the members shall be required for a quorum) and must, include the Chair or Vice Chair and one member nominated by the Retailers, provided that if at any meeting a quorum is not present it will be adjourned to the same time and place 7 days later, and if at the adjourned meeting a quorum is still not present it will be adjourned again to the same time and place 7 days later at which time those members in attendance will constitute a quorum.

5. Voting

- 5.1 Members will have one vote each at Forum meetings.
- 5.2 Decisions of the Forum will require the approval of at least 60% of the Forum members present at the meeting.

Schedule Part 3

Business Plan Agreement Committee

1. The Committee will consist of no less than three nor more than five members, each of whom must be a Forum member, one of whom must be the Chair, one of whom must have been appointed from the publicly advertised posts pursuant to paragraph 1.1.3 of Part 2 of the Schedule and one of whom (a "Retailer Nominee") must have been nominated by the Retailers pursuant to paragraph 1.1.4 of Part 2 of the Schedule (provided that the foregoing requirement for the inclusion of a Retailer Nominee on the Committee shall not apply if no Retailer Nominee is willing to perform such role).
2. The initial member of the Committee shall be such person as is appointed as the initial Chair of the Forum and the Chair shall select the remaining members.
3. The members of the Committee (other than the Chair) may be changed at any time by the Forum in accordance with the procedures in paragraph 2 above on the Chair giving not less than one month's written notice of the proposed changes to Scottish Water (or such lesser period as Scottish Water may agree from time to time).
4. Any member of the Committee who ceases to be a member of the Forum for any reason shall automatically cease to be a member of the Engagement Committee.
5. Decisions of the Committee will require unanimity, with each member of the Committee having one vote.

3

Appendix 3



Network of Economic Regulators – “OECD Studies on the Governance of Regulators”

OECD Peer Review of Stakeholder Engagement in the Charges Determination/ Negotiated Settlement in the Scottish Water Sector

Concept Note

19 January 2017

Purpose and objective

Price setting is a key function of economic regulation. Economic regulators’ methods for price setting have evolved from prescribing the tariffs to be set, towards negotiated settlements and greater stakeholder engagement. This movement is consistent with an overall movement towards engaging stakeholders in the design and delivery of regulation, on which the OECD Regulatory Policy Committee is conducting specific work through the development of Best Practice Principles on Stakeholder Engagement. The review would support Scotland in enhancing the effectiveness of its engagement process in the charges determination and provide a key contribution to the programme of work of the OECD Regulatory Policy Committee and the Network of Economic Regulators.

The OECD review will focus on the process through which the Water Industry Commission for Scotland (WICS), the economic regulator for the Scottish water sector, and Scottish Water, Scotland’s publicly-owned water and sewerage company, engage with stakeholders primarily through a Customer Forum for determining the charges for water services provided by Scottish Water through a negotiated settlement process. The review will build on the peer process of the OECD Network of Economic Regulators (NER) and involve senior officials from regulatory agencies participating in the OECD’s Network of Economic Regulators (NER), who will bring their experience to bear in reviewing stakeholder engagement.

Three components will make up the review:

Component A – Mapping stakeholder engagement institutions and processes

Under this component, the review will:

- Document the different stages of the stakeholder engagement process leading up to the next Final Determination, with a focus on the institutional set-up and the processes to engage with stakeholders;
- Analyse and draw lessons during and at the end of the stakeholder engagement process as it evolves;
- Provide recommendations for enhancing the institutional set-up and process of engaging stakeholders in the determination of service charges.

Component B – Testing tools and approaches to engage stakeholders through behavioural insights

Under this component, the review will:

- Take stock of the different tools and approaches used to engage with stakeholders in the charges determination (for example, information sharing, direct engagement/dialogue etc.);

- Identify alternative tools and approaches that could be used and test them at critical points of the engagement process, using behavioural insights and other relevant expertise;
- Provide recommendations for enhancing the effectiveness of the tools and approaches for engaging stakeholders in the determination of service charges.

Component C – Sharing current approaches to capital maintenance in regulated industries

Under this component, the review will:

- Facilitate learning and exchange of experiences on the identification, monitoring and funding of capital maintenance in industries subject to economic regulation through a workshop/forum to canvass the current approaches that economic regulators, industry, and government use, including on engaging with stakeholders on this issue;
- Document the differing perspectives and approaches to addressing capital maintenance issues shared at the workshop.

Methodology and costing for each of these components are presented below.

Project steering group

The OECD would welcome the establishment of a project steering group including WICS, the Scottish Government, the Customer Forum and any other key stakeholder to facilitate the co-ordination of the activities under the different proposed options.

Background

Customer engagement in the Scottish water sector

As the economic regulator for the Scottish water sector, the Water Industry Commission for Scotland (WICS) determines the maximum amounts of charges for services provided by Scottish Water. The price setting process takes place every six years in accordance with a timeline specified by the Scottish Ministers.

Since 2011, the Customer Forum serves as a platform to present the priorities of customers to Scottish Water and the WICS. In 2012, the Customer Forum was also tasked with agreeing a Business Plan with Scottish Water, consistent with Ministerial Objectives and with guidance from WICS. WICS would take this Business Plan into account in its Draft Determination, which would propose Scottish Water's charges for the period 2015-2021. In January 2014, the Customer Forum and Scottish Water reached agreement on a Business Plan. In March 2014, WICS made a Draft Determination consistent with the Business Plan. This process was documented through interviews with the participants in the process by Professor Stephen Littlechild (Littlechild 2014).

The OECD Network of Economic Regulators, OECD Best Practice Principles for Stakeholder Engagement, water governance and the PAFER methodology

In 2013, the OECD established a global [Network of Economic Regulators](#) (NER) covering the main network sectors (communications, energy, transport and water) to define what it means to be a "world class regulator". The network brings together twice a year over 70 heads, commissioners and senior officials from across the world to discuss issues relevant to all agencies and produce learning and guidance such as the [OECD Best Practice Principles for the Governance of Regulators](#), [Product Market Regulator Survey on Regulatory Management of Network Regulators](#), [independence and accountability of regulators](#) and specific work on the [governance arrangements of water regulators](#).

To help regulators in their quest to better evaluate their performance, the OECD through its Network of Economic Regulators has developed a Performance Assessment Framework for Economic Regulators (PAFER) that looks at the institutions, processes and practices that

help regulators improve their organisational impact, including how regulators engage with stakeholders. The PAFER has been applied to regulators in Colombia and Latvia. Reviews of three Mexican energy regulators and the Irish energy and water regulator are currently underway. Preliminary results of the governance of the energy sector in Mexico will be presented at the next meeting of the NER on 2 November in Paris.

The 2012 *OECD Council Recommendation on Regulatory Policy and Governance* stipulates in principle No. 2 that countries should “Adhere to principles of open government, including transparency and participation in the regulatory process to ensure that regulation serves the public interest and is informed by the legitimate needs of those interested in and affected by regulation. This includes providing meaningful opportunities (including online) for the public to contribute to the process of preparing draft regulatory proposals and to the quality of the supporting analysis. Governments should ensure that regulations are comprehensible and clear and that parties can easily understand their rights and obligations.” (OECD, 2012)

In addition to the 2012 recommendation, the 2008 *OECD Guiding Principles for Regulatory Quality and Performance* set that governments should “Consult with all significantly affected and potentially interested parties, whether domestic or foreign, where appropriate at the earliest possible stage while developing or reviewing regulations, ensuring that the consultation itself is timely and transparent, and that its scope is clearly understood.” (OECD, 2008a)

Also, the APEC-OECD Integrated Checklist on Regulatory Reform mentions the importance of transparency of the regulation-making process, the accessibility of regulations and the regulation making process and its openness and inclusiveness in criteria A5, B4 and B5 (“Are there effective public consultation mechanisms and procedures including prior notification open to regulated parties and other stakeholders, non-governmental organisations, the private sector, advisory bodies, accreditation bodies, standards-development organisations and other governments?”) as well as D4 (“To what extent has the government established effective public consultation mechanisms and procedures (including prior notification, as appropriate) and do such mechanisms allow sufficient access for all interested parties, including foreign stakeholders?”) (OECD 2008b).

The OECD’s Regulatory Policy Committee (RPC) is currently producing a set of Best Practice Principles for Stakeholder Engagement. This new tool for public bodies will be submitted to public consultation and finalised in the course of 2017.

The OECD has also developed Principles on Water Governance, which set standards for more effective, efficient and inclusive design and implementation of water policies. The Principles were welcomed by Ministers at the OECD Ministerial Council Meeting on 4 June 2015.

Additionally, the OECD has released a report on Stakeholder Engagement for Inclusive Water Governance. This report looks at approaches to stakeholder engagement in the water sector in a number of jurisdictions based on a survey and case studies. It also includes principles on stakeholder engagement in water governance, and a set of tentative indicators for monitoring the effectiveness of the engagement process.

Applying behavioural insights to regulatory design and delivery

Through the RPC and the NER, the OECD has developed an extensive body of knowledge on the application of the behavioural insights to regulatory design and delivery. In 2014, the OECD conducted a first mapping of the application of behavioural insights to regulatory policy (OECD 2014a). As part of the OECD initiative on “New Approaches to Economic Challenges” (NAEC), the OECD also organised an international seminar on the institutional practice of behavioural insights and the overall practice of applying them to policy design (OECD, 2015a). In 2016, the OECD through the NER worked with the Colombian Communications Regulation Commission to help them strengthen the consumer protection regime in the Colombian communications market through the use of behavioural insights. **Recommendations from this work and**

further OECD engagement have supported and informed the public consultation, stakeholder review and engagement process in determining the new legislation and regime (OECD 2016a). The OECD will release in 2017 a comprehensive mapping of the applications of behavioural insight to policy based on 130 plus case studies (OECD 2017). This work will also inform a horizontal project on applying behavioural insights to solve complex policy problems to be conducted in 2017-18, bringing together expertise from government, regulators, academia in collaboration with other OECD committees.

Review components

Component A — Mapping stakeholder engagement institutions and processes

Methodology

The review will adapt the PAFER methodology used by the NER to review regulators to review WIC's stakeholder engagement process. This will draw on the OECD Best Practice Principles on the Governance of Regulators, the RPC's forthcoming OECD Best Practice Principles for Stakeholder Engagement and the OECD work on water governance. The review can include four components:

Component 1: Documenting the process

The OECD will conduct interviews with key stakeholders in the engagement process (WICS, Scottish Water, Customer Forum, Scottish Ministries) along the stages of the engagement process, from the inception phase to the finalisation of the Business Plan to contribute to WICS' Draft Determination.

It is expected that the interviews will last approximately 1 hour/1 hour and 30 minutes and will be conducted via teleconference/Skype.

The list of interviews will be agreed with WICS, Scottish Water and the Customer Forum.

The interviews can document:

- **Role clarity:** looking at the roles, objectives and expectations of the engagement process and the extent to which they are aligned with the expectations of the different stakeholders;
- **Input:** documenting the contributions of different stakeholders and the resources and capacity for meaningful engagement;
- **Process:** tracking the processes used for engaging and how these processes contribute to collect the views of customers;
- **Output and outcome:** taking stock of the results of the engagement process and collecting the views of the different stakeholders on the effectiveness and efficiency of the engagement process.

Component 2: Peer review

The OECD Secretariat will conduct the interviews and collect the information described above. At key stages of the engagement process to be identified with inputs from WICS, Scottish Water and the Customer Forum, the OECD Secretariat will organise stock-taking peer missions with a team of 3 senior officials from regulatory agencies participating in the NER. In advance of these stock-taking peer missions, the OECD secretariat will conduct fact finding missions in order to brief the peers.

The stock-taking peer missions could take place at:

- Near the beginning of the engagement process;
- Mid-stage of the engagement process;
- Final stage/completion of the engagement process.

In addition the peers will be consulted in the interview process described in component 1 and where appropriate also be involved. This may also take place during one of the peer missions planned in the project.

As requested, we would endeavour to seek out peers as suggested by WICS for this engagement. The inclusion of a peer from New Zealand will result in additional travel costs, which have been reflected in the budget below. The opportunity of periodic briefings of the NER on the progress of the work could also be considered at different stages of the review.

Component 3: Reporting and committee peer discussion

A final report will document the different stages of the engagement process and include specific recommendations for enhancing the stakeholder engagement process of determining service charges.

- The Scottish stakeholders will have an opportunity to comment and provide feedback on early drafts of the report at the different stages of the project.
- An initial draft of the report will be peer reviewed at a session of one of the meetings of the NER in Paris.
- The final report will be published after the publication of the Final Determination.

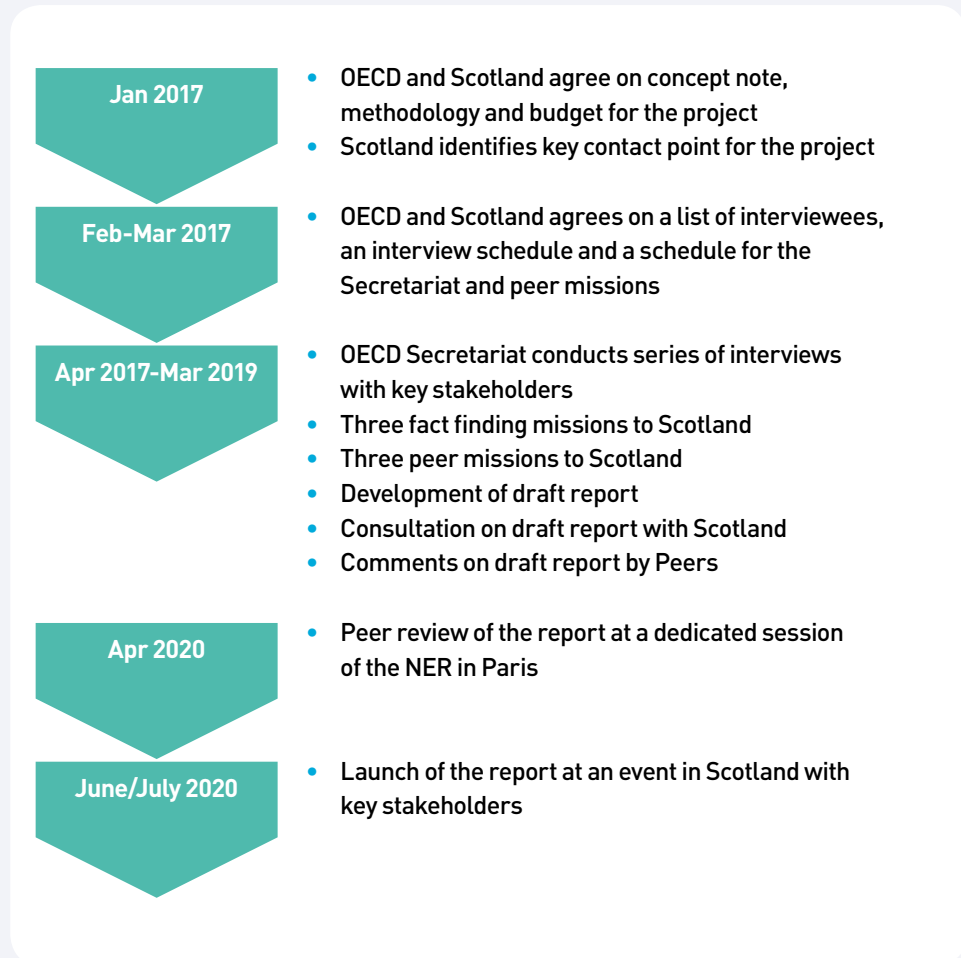
Component 4: Launch

The final report will be presented at an event in Scotland with the OECD, WICS, Scottish Water, the Customer Forum, the Scottish Government and other relevant stakeholders.

Co-ordination

The OECD would welcome a key contract point from the Scottish side to serve as the main counterpart and co-ordinate inputs and exchange information throughout the project.

Tentative schedule of activities and outputs



Component B – Testing tools and approaches to engage stakeholders through behavioural insights

WICS has noted that there may be potential to apply and test behavioural insights during the Strategic Review of Charges. In particular, it has identified two areas in which behavioural insights could be applied:

- the way in which WICS engages with stakeholders on ranges of key inputs to the price review; and
- testing different strategies for engaging with different communities together with the Customer Forum.

Methodology

Component 1: Stocktaking of engagement tools and test planning

The OECD will collect information on the engagement tools that have been used in the past and are expected to be used for the forthcoming charge determination. The stocktaking will be conducted through a questionnaire to be completed by WICS and the Customer Forum.

The OECD will set up a panel of experts from inside and outside the OECD. The panel of experts will be determined in consultation with WICS and the Customer Forum before the project begins.

The panel of experts will provide a mix of expertise on regulation, stakeholder engagement and behavioural insights to be able to provide WICS and the Customer Forum with suitable advice.

On the basis of the information collected through the questionnaire, the expert panel will identify potential areas for testing alternative approaches in light of knowledge and experience on using behavioural insights for interacting with customers and stakeholders. The findings of the expert panels will be presented in an issue note to be shared with WICS.

Component 2: Test design and implementation

On the basis of the expert panel's findings, the OECD will identify a suitable partner for the design and implementation of the tests.

The OECD and the partner will agree with WICS, Citizens Advice Scotland (CAS), Scottish Water, the Scottish Government and the Customer Forum on issues to be tested (way of engagement on ranges of key inputs; engagement strategies with communities or both) and a calendar of tests to be conducted along the engagement process. Testing could be conducted through:

- Laboratory experiments: alternative tools could be tested in a setting that would seek to reproduce the constraints and situation of "real life" but within a laboratory with a sample of subjects recruited for this purpose;
- Field experiments: an alternative tool for engagement could be used for a group of stakeholders (treatment group) while the existing tool would be used for a comparable group of stakeholders (control group);
- Laboratory experiments and field experiments: a mix of these two could also be used.

Component 3: Reporting and committee peer discussion

Findings of the experiments will be presented in a report that will include specific recommendations for enhancing the effectiveness of the tools and approaches for engaging stakeholders in the determination of service charges.

- The Scottish stakeholders will have an opportunity to comment and provide feedback on early drafts of the report.
- A draft of the report will be peer reviewed at a session of one of the meetings of the NER in Paris.
- The final report will be published after the publication of the Final Determination.

Component 4: Launch

The final report will be presented at an event in Scotland with the OECD, WICS, Scottish Water, the Customer Forum, the Scottish Government and other relevant stakeholders.

Co-ordination

The OECD would welcome a key contact point from the Scottish side to serve as the main counterpart and co-ordinate inputs and exchange information throughout the project.

Tentative schedule of activities and outputs



Component C – Sharing current approaches to capital maintenance in regulated industries

Capital maintenance for the existing stock of assets in some industries is needed for the continued delivery of services to consumers. There are some significant capital maintenance projects beyond the 2021-2027 period that may lead to tariff volatility between regulatory periods and the experience of other sectors and regulators could provide useful insights to WICS, the Scottish Government, Scottish Water and customers as they engage in the 2021-2027 strategic review of charges.

Methodology

The role of the OECD in this engagement would be to share and document the experiences of different economic regulators on identifying and communicating on capital maintenance requirements, and would not make specific recommendations on the capital maintenance requirements that would inform the 2021-2027 strategic review of charges.

Component 1: Discussion papers and learning

The OECD would organise a one day workshop to facilitate the sharing of experience and current approaches and perspectives on capital maintenance between economic regulators, regulated industries and governments. In particular, the OECD could structure the discussion around the following issues:

- Forecasting capital maintenance needs:** What techniques are used by regulators and infrastructure operators to identify capital maintenance needs for the current and into future tariff periods? How are these needs quantified for the determination of tariffs?

- **Asset stewardship:** How do stakeholders know that the infrastructure operator is undertaking the allowed capital maintenance? What mechanisms are used to monitor and incentivise that forecast capital maintenance needs are undertaken during the regulatory period?
- **Stakeholder engagement:** How do infrastructure operators, economic regulators, and government engage with stakeholders to explain the need to recover the costs of capital maintenance?

The OECD would commission experts to develop discussion papers on the above themes, and subsequently prepare a briefing paper to circulate to workshop participants.

The OECD would then invite representatives from government, industry, and economic regulators to set out their current approaches to addressing these issues at the workshop.

In order to encourage economic regulators to attend the workshop and share their experiences, the OECD could host the workshop in Paris, back-to-back with the meeting of the Network of Economic Regulators (NER).

Component 2: Report

In conjunction with the experts, the OECD would use the discussion at the workshop to finalise the discussion papers and produce a report documenting setting out the different approaches to addressing capital maintenance issues and different perspectives on these issues shared at the workshop. The report would be presented at a session of the Network of Economic Regulators, and launched at an event to be agreed with Scotland.

Tentative schedule of activities and outputs



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4

The Timeline for the Strategic Review of Charges 2021-27

Key

Major Process Milestone

Commission contact point with stakeholders

Key Commission milestone

Appendix 4

Date	Event	Description
February 2017 (complete)	Co-operation Agreement	The Commission, CAS and Scottish Water discuss and agree the Co-operation Agreement establishing the Customer Forum – see Appendix 2.
February 2017 (complete)	Commissioning letter	The Scottish Government publishes the Commissioning letter for the Strategic Review of Charges 2021-27 (SRC21) and provides associated guidance to the Commission – see Appendix 1.
10 April 2017	Methodology	The Commission publishes this methodology document.
15 May 2017	Customer Forum	The Customer Forum for SRC21 is established.
May 2017	OECD Review	The OECD peer review team meet with the Commission, the Scottish Government, SEPA, DWQR, CAS, Scottish Water and the Customer Forum.
May 2017	Information to Commission	The Commission receives for comment draft Decision Papers on initial ranges for capital program size and definition, prospects for prices and a ready reckoner.
June 2017	Commission meeting	The Commission decides on initial ranges for capital program size and definition, prospects for prices and a ready reckoner.
21 June 2017	Papers are published	The Commission publishes Decision Papers on the initial ranges for capital program size and definition, prospects for prices and a ready reckoner.
July 2017	Information to Commission	The Commission receives for comment draft Decision Papers on initial ranges for growth, capital enhancement inflation, interest rates, other macro-economic assumptions and service level maintenance.
August 2017	Commission meeting	The Commission decides on initial ranges for growth, capital enhancement, inflation, interest rates, other macro-economic assumptions and service level maintenance.
August 2017	Commission Meeting	The Commission has a discussion with SEPA and DWQR on the prospects for the Strategic Review of Charges 2021-27.
August 2017	Commission Meeting	The Commission has a discussion with the Customer Forum on the prospects for the Strategic Review of Charges 2021-27.
23 Aug 2017	Papers are published	The Commission publishes Decision Papers on initial ranges for growth, capital enhancement, inflation, interest rates, other macro-economic assumptions and service level maintenance.
September 2017	Information to Commission	The Commission receives for comment draft Decision Papers on initial ranges for operating expenditure, financial strategy, the approach to innovation, and performance monitoring.
October 2017	Commission meeting	The Commission decides on initial ranges for operating expenditure, financial strategy, the approach to innovation, and performance monitoring.
October 2017	Joint Stakeholder meeting	The Commission meets with Scottish Water, SEPA, DWQR, CAS, the Scottish Government and the Customer Forum to discuss SRC21 key issues.

Date	Event	Description
25 October 2017	Papers are published	The Commission publishes Decision Papers on initial ranges for operating expenditure, financial strategy, the approach to innovation, and performance monitoring.
December 2017	Joint Board meeting	Scottish Water Board meets with the Commission to discuss SRC21 in the light of the initial range papers.
January 2018	Commission meeting	The Commission receives an update on SRC21 prospects and key areas for further work.
January 2018	Commission meeting	The Commission meets with the Scottish Government and CAS to discuss SRC21 and developments in consumer policy.
February 2018	25 year Strategic Projections	Scottish Water publishes its draft 25-year Strategic Projections document for consultation.
March 2018	Commission meeting	Scottish Water presents its draft 25-year Strategic Projections document to the Commission.
April 2018	Draft Principles of Charging and Investment Objectives	The Scottish Government issues its draft Principles of Charging and Investment Objectives.
May 2018	Customer Forum & Commission	The Customer Forum and the Commission discuss the draft 25-year projections document and SRC21 key issues.
May 2018	Joint Stakeholder meeting	The Commission meet with Scottish Water, SEPA, DWQR, CAS, the Scottish Government and the Customer Forum to discuss SRC21 key issues.
June 2018	Information to Commission	The Commission receives for comment draft Decision Papers on revised ranges for capital program size, prospects for prices and a ready reckoner.
July 2018	Commission meeting	The Commission decides on revised ranges for capital program size, prospects for prices and a ready reckoner.
25 July 2018	Papers are published	The Commission publishes Decision Papers on revised ranges for capital program size, prospects for prices and a ready reckoner.
August 2018	Information to Commission	The Commission receives for comment draft Decision Papers on revised ranges for growth, capital enhancement, inflation, interest rates, other macro-economic assumptions and service level maintenance.
September 2018	Commission meeting	The Commission decides on revised ranges for growth, capital enhancement, inflation, interest rates, other macro-economic assumptions and service level maintenance.
26 September 2018	Papers are published	The Commission publishes Decision Papers on the revised ranges for growth, capital enhancement, inflation, interest rates, other macro-economic assumptions and service level maintenance.
October 2018	Information to Commission	The Commission receives for comment draft Decision Papers on the revised ranges for operating expenditure and the revised approaches to financial strategy, encouraging innovation, and performance monitoring.
November 2018	Commission meeting	The Commission decides on revised ranges for operating expenditure and the revised approaches to financial strategy, encouraging innovation, and performance monitoring.
21 November 2018	Papers are published	The Commission publishes Decision Papers on the revised ranges for operating expenditure, and the revised approaches to encouraging innovation, financial strategy and performance monitoring.

Date	Event	Description
December 2018	Joint Board meeting	Scottish Water Board meets with the Commission to discuss SRC21 in the light of the revised range papers.
December 2018	Joint Stakeholder meeting	The Commission meet with Scottish Water, SEPA, DWQR, CAS, the Scottish Government and the Customer Forum to discuss SRC21.
January 2019	Commission meeting	Scottish Water presents on the likely content of their Business Plan.
March 2019	Commission meeting	The Commission receive an update from the Scottish Government and CAS on Consumer Policy.
May 2019	Draft Business Plan	Scottish Water publishes its final 25 year Strategic Projections and its Draft Business Plan for the 2021-27 period.
May 2019	Commission meeting	Scottish Water present their Draft Business Plan to the Commission. The Commission provides initial views on the Draft Business Plan.
June 2019	Joint Stakeholder meeting	The Commission meet with Scottish Water, SEPA, DWQR, CAS, the Scottish Government and the Customer Forum to discuss SRC21.
June 2019	Information to Commission	The Commission receives for comment a draft of the proposed final ranges and approaches for SRC21.
July 2019	Commission meeting	The Commission decides on the final ranges and approaches for SRC21.
24 July 2019	Papers are published	The Commission publishes its final Decision papers on the key regulatory parameters for SRC21.
August to September 2019	Agreement on Business Plan	Scottish Water and the Customer Forum seek to reach agreement on the Business Plan within the parameters set by the Commission and consistent with the draft Principles of Charging and Investment Objectives set by Ministers. If they reach agreement, Scottish Water and the Customer Forum notify the terms of the agreement to the Commission. If they do not reach agreement, Scottish Water and the Customer Forum separately set out their reasons for not reaching agreement.
September 2019	Commission meeting	The Commission discusses with the Customer Forum and Scottish Water their progress towards agreement.
November 2019	Draft Determination	If the Commission determines that an agreement has been reached between the Customer Forum and Scottish Water which is fully consistent with their published ranges and the draft Principles of Charging and Investment Objectives set by Ministers, the Commission will translate this agreement into their Draft Determination. If no agreement has been reached or the Commission determines that the agreement between the Customer Forum and Scottish Water is not fully consistent with the published ranges and/or the draft Principles of Charging and Investment Objectives set by Ministers, the Commission will prepare a Draft Determination based on its final range papers.
November 2019	Commission meeting	The Commission agree the Draft Determination.
30 November 2019	Draft Determination published	The Commission publishes the Draft Determination.
December 2019	Final Principles of Charging and Investment objectives	The Scottish Government publishes its final Principles of Charging and Investment Objectives.
December 2019	Joint Board meeting	Scottish Water Board meets with the Commission to discuss the Draft Determination.
January 2020	Commission meeting	The Commission reviews responses to the Draft Determination.

Date	Event	Description
January 2020	Joint Stakeholder meeting	The Commission meet with Scottish Water, SEPA, DWQR, CAS, the Scottish Government and the Customer Forum to discuss the Draft Determination.
March 2020	Commission meeting	The Commission agree the Final Determination.
31 March 2020	Final Determination published	The Commission publishes the Final Determination.
May 2020	CMA referral Deadline	Scottish Water decides whether or not to accept the Final Determination.
October 2020	Joint Stakeholder meeting	The Commission meet with Scottish Water, SEPA, DWQR, CAS, the Scottish Government and the Customer Forum to discuss the Final Determination.
December 2020	Commission meeting	Scottish Water briefs the Commission and the Customer Forum on its proposals for its Delivery Plan.
December 2020	Joint board meeting	Scottish Water Board meets with the Commission to discuss the Final Determination and the Delivery Plan.
March 2021	Delivery Plan	Scottish Water submits its Delivery Plan for the 2021-27 period to the Scottish Ministers for approval.



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