

03 February 2022

Douglas Millican  
Chief Executive  
Scottish Water  
Castle House  
6 Castle Drive  
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Dunfermline  
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**Your Ref:**  
22-23 Charges Scheme Approval

Dear Douglas,

### **Charges Scheme for 2022-23: Approval**

On 2 February 2022, Scottish Water submitted a revised Charges Scheme to the Commission. The Charges Scheme covers the period 1 April 2022 to 31 March 2023 and contains the proposed retail charges from Scottish Water to customers and wholesale charges from Scottish Water to Licensed Providers. The proposed revised Charges Scheme sets out a 4.2% increase in all household and wholesale primary charges.

This letter explains the Commission's response to your revised Charges Scheme. The Commission notes the following issues:

1. Our Final Determination set out a 2% average annual real increase in charges from 2021-22 to 2026-27. The 1.8% increase in charges for 2021-22 and the proposed 4.2% increase in charges for 2022-23 implies that Scottish Water is raising less revenue relative to the level allowed for in the Final Determination. As a result, charges would now need to increase by more than CPI+2% in each of the next four years if future customers are not to be disadvantaged. Even if charges increase sufficiently to recover the revenue shortfall by 2026-27, our modelling indicates that the cash available for investing in maintaining services, drinking water quality, environmental improvements and supporting economic growth will be in excess of £100 million lower than the level we allowed for in the Final Determination.

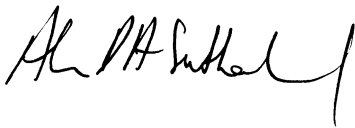
2. Based on market expectations<sup>1</sup>, it appears unlikely that the CPI October 2022 figure will fall below the October 2021 CPI figure of 4.2%. If such inflationary pressure were to persist, the increase in Scottish Water's charges from 2023 would have to be much higher in nominal terms.
3. Given that any elevated nominal increases in charges will always be challenging, it is not clear to us how Scottish Water now plans to be able to deliver in full the Scottish Ministers' Objectives. Even if the increases required to bring revenues in line with the Final Determination were possible, delivery of the Objectives will inevitably be impacted by the shortfall in capital resulting from the increases adopted in the first two years of this regulatory control period.
4. There are, in addition to this, recent developments and uncertainties that may further impact Scottish Water's capacity to deliver against its commitments:
  - Scottish Water has allocated additional capital investment in the range of £300m - £400m on improving the performance and monitoring of combined sewer overflows. At least half of this investment is expected to be delivered before 2027 and would be in addition to what was envisaged in the Final Determination.
  - The increase in costs as a result of the national lockdowns in response to the Covid-19 pandemic, as set out in Scottish Water's Interim Report and Accounts for the six months to 30 September 2021;
  - Capital inflation increases above CPI resulting from the lack of available materials and labour within the supply chain, which Scottish Water is expected to absorb in full; and
  - Uncertainty around the level of demand growth from the non-household customer base from 2020 and how this could adversely impact Scottish Water's revenue and thus available investment.
5. Whilst Scottish Water has coped well with some of the challenges due to extreme weather conditions in the current year, delaying investment on climate change adaptation and mitigation will, ultimately, impact Scottish Water's performance and increase future costs.

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<sup>1</sup> Investec Global (Economic Overview, 24 January 2022), the Bank of England ([Update](#), 17 December 2021) and the Office for Budget Responsibility (Economic and Fiscal Outlook October 2021) do not expect inflation to revert below 4% in Q2 of 2022/23.

The Commission has approved your revised Charges Scheme but its approval is conditional on our receiving in due course a full explanation from Scottish Water as to how it will manage its costs and revenues and deliver the required investment, in a manner consistent with our Final Determination of Charges, during the remainder of this regulatory control period.

Yours sincerely,



**Alan D A Sutherland**  
Chief Executive