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July 2020

Thank you for your letter of 28 April offering the Commission's advice as to how to proceed with the Strategic Review of Water Charges 2021-27. This has provided a very helpful framework for me to consider these issues in the light of the developing situation relating to COVID-19 and the planning for economic recovery.

I have taken careful note of your advice on the timetable within which decisions and determinations are required. In making these decisions, we need to ensure we have the best understanding of the wider context. We need also to ensure that Scottish Water has sufficient certainty to be able to plan its operations and investment programme.

I recognise that under the relevant legislation, Scottish Water cannot set charges in the absence of a determination. In order to allow Scottish Water to make a Charges Scheme for 2021-22 by the latest practicable date in January or February next year, you consider the latest date for publication of a Draft Determination would be the middle of October 2020. This would allow time for stakeholders to comment on the Draft Determination, before the Commission published its Final Determination in the second half of December 2020. It would also allow around four to six weeks for the Scottish Ministers to finalise our Objectives and the Statement on the Principles of Charging, which we would do within that timetable. I am content to proceed on that basis, although I would be grateful if you could keep closely in touch with my officials to ensure that the fullest understanding over that period of the actions being taken in relation to the economic recovery are reflected in those processes.

It is clear that there are many factors which remain uncertain at this stage and I wish to ensure that we are able to respond appropriately as they develop during the recovery. In particular, we need to ensure we take full account of the impacts on Scottish Water in terms of the size of the revenue base, lost revenue, bad debt and the likely backlog of 2015-21

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investment, all of which have implications for 2021-27 but which may not be fully understood until later in the year.

I have considered carefully the options you set out in relation to the length of the next regulatory period. I understand that your key concerns here are how best to provide some flexibility on charges to respond to the economic circumstances while maintaining satisfactory progress towards the higher levels of investment that have been identified as necessary for Scottish Water to achieve the Objectives set by Ministers. Significant in those Objectives are the commitment to net-zero emissions by 2040 and the implementation of its asset management plan to tackle the implications of its aging asset base. The importance of Scottish Water's transformation plan is also evident. I have noted your comment that lower charges in the early years of the period inevitably mean higher charges for customers in future years and that the issue of how the burden can be equitably shared between present and future customers is important. I agree we need to take full account of all these issues.

I agree that the options of deferring the start of the new regulatory period are not practicable and we should set them aside.

I note your recommendation of a longer regulatory period, preferably up to 15 years, and I understand the reasons why you advocate this approach. I have noted how you think some policy flexibility for Ministers could be accommodated within such a longer period. I am glad that you recognise that this is a concern from Ministers' point of view. However, having looked at the approach you suggest with some care, I do not think it is sufficient to meet this concern and Ministers would find it difficult to explain to Parliament and wider stakeholders. I am therefore not persuaded to extend the present 6 year period.

However I agree it is important that we remain focused on the longer term sustainability of Scottish Water. We must therefore be able to take proper account of the longer term implications of decisions which may be considered in response to shorter term pressures.

The Government's letter of 31 January 2017, as updated on 26 June 2019, commissioning the present strategic review of charges, asks the Commission to indicate charge levels for the period beyond 2021-27, and you have done so in Prospects for Prices. Such advice provides an important context for understanding the factors in the preceding paragraphs. In order to fulfil that purpose more fully, it would be helpful for this advice to extend to 2040. The key assumptions made, in particular the average annual level of investment assumed to have been achieved at 2027 and 2033 should be clearly stated. The impacts on that longer term scenario of decisions taken in 2021-27 could then be clear.

I understand why the Commission consider that a floor, or collar, to charge rises has merits. However, the legislation provides for the determination of maximum amounts of charges only, and Ministers are not able to require minimum charge levels as part of the determination. It is a matter for the Commission as to whether they wish to develop this approach further in discussion with Scottish Water.

The level of investment required of Scottish Water is obviously a key determinant of charge levels. A lower investment requirement might therefore reduce the burden on customers in 2021-27. However, Ministerial Objectives have just been endorsed following our second public consultation and the drivers to investment cannot easily be revised. Indeed, failure to meet investment targets will increase the risk of failure in the system and worsening of

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performance which would be unacceptable to consumers. We are unwilling to accept greater risks in areas key to public health and environmental improvement. In addition, the Government is clear about the importance of green investment within the overall plan for post COVID recovery. This Green Recovery will mean that Scottish Water's target to achieve net zero emissions by 2040 will become even more important.

Nevertheless, I recognise that the charge path set out in Prospects for Prices will be seen as challenging for many customers and the COVID shocks to the economy will have implications for many. Water charges are only one of the burdens that they will face and decisions yet to be taken in many areas eg on council tax will be important to the overall context. Ministers expect Scottish Water to take close account of these factors in drawing up their charging schemes and in doing so, to work through the proposed national engagement programme to maintain an open dialogue with customers on the issues they face.

You will have noted calls for water charges to be frozen. While it would be for Scottish Water to decide whether freezing charges in nominal or real terms in any particular year is the best way of addressing the circumstances it and its customers face, I do not think a simple freeze is practicable given the continuing investment challenges SW faces.

However, I wish to ensure that collectively we are as sensitive as possible to the circumstances faced by customers facing difficulty in paying. Because water charges will remain linked to Council Tax, it is impracticable to step outside the existing framework of discounts. But I wish to address again what can be done within that framework. We had already proposed in our most recent draft of the Principles of Charges to increase the level of discount available through the Water Charges Reduction Scheme (WCRS) to assist particularly vulnerable customers. I therefore want to consider further increasing that discount to 35%. This will be worth more than simply freezing charges for those customers.

A higher level of borrowing by Scottish Water could have a short term impact of reducing charge rises but at the longer term cost of increasing interest payments and the burden on future customers. You should therefore continue to assume total lending of £1,020 million being available over 2021-27, as set out in the recent consultative draft of the Principles of Charges. As usual, lending in any year will be subject to the Government's budgetary processes. In advising on charges for subsequent periods, in line with the paragraphs above, it would be helpful for the Commission to show the impacts of different levels of borrowing by Scottish Water in future periods.

This letter supplements the previous commissioning letters of 31 January 2017 and 26 June 2019.

ROSEANNA CUNNINGHAM

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