

Douglas Millican

1 July 2022

Castle House
6 Carnegie Ave
Dunfermline
KY11 8GG

Dear Douglas

INFORMATION REQUEST RELATING TO WICS' APPROVAL OF 2022/23 CHARGES SCHEME

On 3rd February 2022, WICS approved the Charges Scheme for the financial year 2022/2023 conditional on receiving a full explanation as to how Scottish Water planned to deliver the Ministerial Objectives for the regulatory control period 2021 to 2027. It is critical that Scottish Water makes progress in providing all the information requested – either in its requested, or an appropriate and agreed, form by 31 August 2022.

Background to the information request

WICS' regulatory approach is based on Scottish Water taking full ownership of its current performance and future strategy. There is a clear expectation that WICS and other stakeholders require an improved visibility and transparency of expenditure and performance.

The Scottish Ministers, in their Objectives for the 2021-2027 regulatory control period, require that the water industry make reasonable progress towards achieving the industry vision. In the Final Determination, WICS outlined the level of future annual average investment likely to be required by 2040 if Scottish Water were to manage and optimise its asset base and operate in a manner consistent with a net zero position for both operational and embodied greenhouse gases.

This level of investment was based on a continuing annual efficiency factor of 1% per annum each year between 2017/18 (the base year for the price review) and 2040. WICS also set an average annual target for efficiency in operating and other recurring costs of 1% per annum. WICS' Final Determination set out these challenges and explained that average annual charges would have to increase at an average of around 2% above the rate of CPI each year if Scottish Water were, by 2040, to have the funding available sustainably to deliver investment of around £1 to £1.1 Billion each year (in 2017/18 prices) by 2040. Scottish Water accepted this Determination and the revenues and costs allowed for therein.

There is flexibility on how charge levels are transitioned to the required level – but the Final Determination explained that achieving the agreed long term vision for the industry would require the funding to be in place to allow for capital expenditure of an average of £1 to £1.1 Billion each year (in 2017/18 prices) by 2040.

WICS, First Floor, Moray House, Forthside Way, Stirling FK8 1QZ

Chair: Professor Donald MacRae OBE FRSE

01786 430 200 | enquiries@wics.scot | wics.scot | scotlandontap.gov.uk

In setting charge caps for the 2021-2027 regulatory control period, WICS opted to set a profile – an average annual charge cap of CPI+2% - consistent with the average annual change and the associated investment that was identified as likely to be required by 2040. In light of this, WICS also explained that increases below the allowed for average annual charge cap could disadvantage future customers – both in terms of increases in charge levels and lower levels of service quality and reliability. WICS' decisions in its Final Determination reflected its duty to have regard to the interest of future customers.

Importance of completing the information request

As we made clear in our February letter, the information request will allow WICS to understand the pressures faced by Scottish Water and how it proposes to meet the challenges of this regulatory control period recognising the challenges that lie ahead in the subsequent years to 2040. The information request is of the utmost importance particularly given the investment and performance implications of the tariff decisions for the last two financial years of the current regulatory period.

In recent weeks, WICS has also noted the most recent forecasts of the Bank of England, which suggest that CPI may exceed 11% later in 2022. This is some 3 percentage points higher than the worst-case estimates that were available at the time WICS approved the Scheme of Charges. Inflation in future years have also seen upward revisions albeit by not the same magnitude at this time, which will impact Scottish Water's ability to invest and may impact performance.

The information request is now even more essential to retaining confidence that Scottish Water is making the required reasonable progress to address the current and future challenges facing the industry. It is designed to confirm the extent of progress that Scottish Water expects to make. WICS considers that it is important to be explicit about what will be possible.

As noted previously, WICS expects a full return by 31 August 2022. WICS will continue to engage with Scottish Water as it completes the request and as it sets out how it plans to deliver during the current regulatory control period.

Next Steps

Scottish Water has not made WICS aware of any new information that could reduce the likely average annual level of investment required by 2040. As such, the 2040 level of revenue envisioned in WICS' Final Determination appears to remain consistent with the best evidence available. WICS recognises that the transition of charges over this extended period will have to reflect Scottish Water's underlying finances (improvement in efficiency and its cash balances), the expectations of its customers as reflected in the current Principles of Charging, the level of borrowing available and investment pressures. Each of these factors could impact the actual annual increase in charges that Scottish Water may adopt, subject, of course, to the regulatory control period cap not being breached.

Scottish Water is clearly operating in an increasingly complex environment. It faces Covid delays, supply chain cost pressures and a cost of living crisis. As such, it may not be possible to deliver

efficiently and effectively as much capital expenditure in this regulatory control period as was originally envisioned. A lower level of capital expenditure could mean that Scottish Water won't make as much progress in transitioning to the point where it can replace its assets in an economically optimal way. Such a delay may impact service to customers. The impacts of this may be best considered under the interim determination process allowed for under Section 29F of the Water Industry (Scotland) Act 2002.

It is open to Scottish Water, in responding to the information request, to suggest a change in the profile of charges within the current regulatory control period as long as any changes were consistent with Scottish Ministers' current Objectives and Principles of Charging.

It is worth emphasising that the 2040 target and all the other Objectives specified for the 2021-2027 regulatory control period could only change if the Scottish Ministers were to commission a Strategic Review of Charges and issue a new statement of the Principles of Charging and new Objectives for the industry.

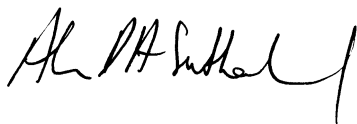
WICS considers it critical that there is a clear plan in place for this regulatory control period that takes into account the events of the past two years. We would expect that a satisfactorily completed information request with appropriate commentary would form the basis of this plan.

The information requested includes the proposed profile of prices, borrowing and use of cash balances over the regulatory control period. A completion in full would require Scottish Water to specify the cash resources it expects to have available over the regulatory control period. Given these available cash resources and the inevitable uncertainties, it would also require Scottish Water to set out the potential options for investment and other expenditures that it would be in a position to deliver. WICS recognises that, if further and improved evidence comes to light, any such priorities could change.

The information request and supporting commentary should also take account, in line with the current Principles of Charging, of the current pressures on household and non-household budgets and the need to continue to offer reliable levels of service to its customers. We would expect Scottish Water to be clear as to what levels of service customers will receive and the potential implications of different choices where such choices are realistic.

WICS stands ready to work constructively with Scottish Water in determining the most appropriate way forward in the remainder of the current regulatory control period.

Yours sincerely,



Alan D A Sutherland
Chief Executive