

**Douglas Millican**  
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Scottish Water  
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21 March 2022

**Your Ref:**  
Information Request

Dear Douglas

### **Reporting quality and completeness improvement plan**

The Strategic Review of Charges 2021-27 envisioned Scottish Water taking ownership of its strategy and investment decisions. The aim was to enable Scottish Water to seek greater value for customers through greater innovation and collaboration. Importantly, there was a clear expectation that Scottish Water's regulators could expect more and better targeted information than previously. I wrote to you in December, to highlight WICS' concerns about Scottish Water's response to the Strategic Review of Charges. In particular, I highlighted concerns related to:

- the quality and completeness of Scottish Water's regulatory reporting;
- Scottish Water having not provided visibility on future investment needs required by the Investment Planning and Prioritisation Framework; and
- Scottish Water having made limited progress in taking forward the high-level asset replacement work.

The response to that letter from the Director of Strategic Customer Service Planning (received on 13<sup>th</sup> February but dated 31 January) does not address the concerns highlighted in my letter in full. I am therefore writing to provide WICS' views on:

- the concerns that have not been addressed;
- WICS' immediate priorities; and
- the methodology for the Strategic Review of Charges 2027.

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## **Concerns that have not been addressed**

### Reporting quality and completeness

WICS welcomes the open approach that Scottish Water's consultants have adopted in conducting an external review of the annual return process.

However, the letter dated 13th December requested that Scottish Water provide a draft of its plan by 31st January and for that draft to set out how Scottish Water will improve regulatory reporting, in terms of scope, completeness and accuracy. The letter also set an expectation that the plan would be agreed by the start of the next information cycle.

While the response to the letter refers to the three outcomes that Scottish Water's improvement plan will focus on, WICS is yet to see a draft of the improvement plan. As such, WICS is unclear how Scottish Water will meet the requirements of the Annual Return and Regulatory Accounts 2023. WICS is also unclear about the process that Scottish Water proposes to follow to finalise that plan ahead of the next reporting cycle.

### Visibility of future investment needs

The Final Determination allowed for £4.5 billion of investment (later restated to £4.8 billion following improvements to Scottish Water's systems of cost capture), which was consistent with Scottish Water delivering the water sector vision by 2040.

Despite the response to the information request, WICS is not further forward in understanding the investment that will be delivered over the 2021-27 regulatory period (i.e. the 'baseline') in the context of the possible future investment needs and opportunities. WICS requested such a baseline in its information request that followed the conditional approval of Scottish Water's Scheme of Charges for 2022/2023. Such a baseline allows future changes to be appropriately assessed and understood. WICS would expect a baseline to set out clearly:

- What Scottish Water is planning to deliver;
- By when, including intermediate dates allowing progress to be understood;
- At what expected cost; and
- And with what impact (levels of service, compliance, growth etc.)

In the absence of such a baseline, WICS is unable to understand whether:

- Scottish Water is making adequate progress towards delivering the water sector vision;
- customers will receive the investment that they have paid for over the 2021-27 regulatory control period; and
- customers will be asked to pay twice for the delivery of the same output.

Moreover, it is now apparent that customers will not receive full investment underpinning the Final Determination, not least because the Final Determination did not include the transformation investment of over £300m and it appears that Scottish Water will not realise the cash savings that it said it would generate from the transformation programme within the current regulatory control period. It also did not include the investment to improve the performance and monitoring of combined sewer overflows of £150m to £200m.<sup>1</sup> Both factors have the effect of displacing the allowed for investment underpinning the Final Determination.

The response to the letter of 13th December did not set out how and by when Scottish Water will provide this visibility.

#### Progressing the high-level asset replacement work

The response to the letter of 13th December explained that Scottish Water had been working with Oxera, Northumbrian Water, Sydney Water and WICS on a programme of work in relation to asset replacement and, while that programme has 'petered out', Scottish Water has continued to work with Northumbrian Water and others to progress the work.

WICS is under the impression that this work paused many months ago. WICS would therefore like to understand the specific work that Scottish Water has continued with Northumbrian Water and others.

It is also important to note that the response to the letter of 13th December does not set out how Scottish Water will address the potential improvements that can and should be made to the current Management Approaches. As explained, it will be important that Scottish Water highlights to stakeholders in a consistent and transparent way:

- what choices are being made;
- how they are being made; and
- what the implications of the choices being made are for current and future customers.

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<sup>1</sup> Based on the Scottish Water 'Improving Urban Waters – Route Map', p.4. The price base is not specified in the document.

Given WICS' duties towards current and future customers, it is important that WICS has this information to ensure that customers receive the investment that they have paid for and to keep a record of the asset replacement investment that is not progressed and will need to be met by future customers.

### **WICS immediate priorities**

Moving forward, WICS' immediate priorities relate to the nature and scope of regulatory accounting rules and reporting of investment.

In relation to the regulatory accounting rules, WICS' underlying concerns set out in the letter of 13th December (and accompanying appendix) remain. Further work is therefore required across a wide range of areas, including:

- the investment baseline;
- the definition of core and non-core;
- based on this definition, which of these business activities would be considered core or non-core; how costs are recognised as operating or capital expenditure (i.e. capitalisation rules) within the core business;
- how those costs are allocated to the different business activities; and
- transfer pricing between these core and non-core activities.

WICS will commence this work in April.

In relation to the reporting of investment, WICS' priority is for Scottish Water to provide this visibility for the 2021-27 regulatory control period, to allow for monitoring of delivery through regulatory reporting. As Scottish Water is now a third of the way through the current regulatory control period in terms of elapsed time, WICS considers that this is a matter of high urgency and importance. As such, WICS requests that Scottish Water provides its planned milestones and timescales for providing this information for the agreement of WICS.

### **How the priorities relate to the methodology for the Strategic Review of Charges 2027**

WICS' planning for the Strategic Review of Charges 2027 (SRC27) is well underway. WICS' current expectation is to issue a high-level methodology in June 2023. WICS' expects that this will cover the areas outlined above and set out the strategic questions for the SRC27, including:

- How will Scottish Water evidence its average annual replacement cost that it should charge customers such that it can maintain its assets appropriately, in the light of the climate adaptation and mitigation challenges that it faces?

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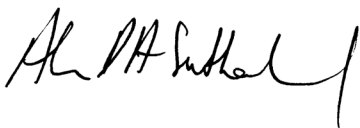
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- How will Scottish Water evidence the options for moving towards the sustainable funding of the industry?
- How will Scottish Water evidence full transparency of the incidence of costs and the funding and financing of core and non-core activities?
- How will Scottish Water evidence that its proposals for operating expenditure are efficient and effective for the SRC27?
- How will Scottish Water evidence that its resources for asset replacement, repair and refurbishment are used efficiently and effectively?
- How will Scottish Water develop the 'universe of needs' – a list of all known needs and aspirations that Scottish Water might, at some point, be expected to deliver?
- How will Scottish Water set out the implications of future investment on levels of service and compliance, in order to provide a baseline for performance to be assessed?

In relation to the first of these areas, for example, WICS will draw on the most recent evidence, which may be the work that Scottish Water has progressed with Northumbrian Water and others. In the absence of more recent evidence, WICS will revert to Scottish Water's analysis that informed the 2019 Decision paper on the asset replacement challenge.

WICS' current expectation is that it will then publish a detailed Final Methodology and Guidance at the end of the 2023.

Yours sincerely,



**Alan D A Sutherland**  
Chief Executive

Copy of letter to:

Jon Rathjen, Deputy Director, Scottish Government