

# STRATEGIC REVIEW OF CHARGES 2027-2033: FINAL METHODOLOGY APPENDICES

12 December 2024

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# Appendices

## Appendix 1 - We asked, you said, we did

### 1.1. Overview of appendix

We received nine responses to our draft methodology from the following organisations:

- Business Stream;
- The Consumer Council for Water (CCW), which is the consumer advocacy body for the water industry in England and Wales;
- Consumer Scotland;
- Drinking Water Quality Regulator (DWQR);
- The Independent Customer Group (ICG), which is Scottish Water's internal customer challenge group;
- Market Operator Services Limited (MOSL), which is responsible for managing customer switching and settlement in the non-household retail market in England and Wales;
- Scottish Environment Protection Agency (SEPA);
- Scottish Water; and
- Waterwise.

This appendix provides an overview of how we have taken account of responses to our draft methodology consultation in our final methodology. Each section of this appendix sets out:

- **Chapter introduction:** a summary of our proposals from the relevant chapter(s) in the draft methodology;
- **We asked:** the consultation question that we asked;
- **You said:** a high-level summary of the consultation responses to the relevant question, focusing particularly on those that required updates to our approach; and
- **We did:** any resulting change(s) in our final approach compared to the proposed approach in the draft methodology.

Whilst there was no consultation question for chapter 15, several consultation responses made points relating to chapter 15, which we cover in section 1.13.

### 1.2. Chapters 1 to 4: Introduction, overview and scene setting

#### CHAPTER INTRODUCTION

In our draft methodology, chapters 1 to 4 set out:

- an introduction to the draft methodology;
- an overview of the water industry in Scotland;

- detail on the Strategic Review of Charges process, i.e. the role of stakeholders and key milestones; and
- background and context for SRC27, including the challenges and opportunities within the water industry, developments following SRC21 and the expectations from the Commissioning letter for SRC27.

## **WE ASKED**

### **Question 1: Do you have any views to share on chapters 1 to 4?**

## **YOU SAID**

### *Ethical Business Practice and Regulation*

There was agreement across stakeholders welcoming our commitment to Ethical Business Practice and Regulation (EBP&R). Consumer Scotland asked for a joint session to learn how EBP&R has evolved into Outcome Based Cooperative Regulation (OBCR).

### *Net zero and intergenerational fairness*

Stakeholders agreed that addressing climate change will be key in the upcoming period. Scottish Water noted that this requires long-term planning. Scottish Water also noted the need for intergenerational fairness when setting charges.

In relation to Government policy, Consumer Scotland highlighted that a transition to net zero should be just and accommodate those least able to pay more.

### *Investment priorities and benefits*

Consumer Scotland highlighted that they would welcome greater clarity on how investment initially planned for SRC21 will be funded, or whether it will be accepted that this investment is now not going to be delivered. Consumer Scotland and the Independent Customer Group (ICG) asked for more information from Scottish Water on how they will respond to future unforeseen circumstances. The ICG welcomed a commitment to a formal review of the framework (should these circumstances arise) to establish whether its provisions should be adjusted to reflect the new reality.

Consumer Scotland also welcomed the focus on creating greater transparency of the benefits customers will receive for what they pay, and they support the consideration of additional measures to provide assurance that Scottish Water is delivering on service needs and value for money.

### *Customer engagement*

Consumer Scotland encouraged partnership working with customers and communities to fulfil the duties of the Place principle as set out within the Commissioning letter.

The Consumer Council for Water (CCW) emphasised the importance of evidence from customer engagement.

### *Retail market*

Market Operator Services Limited (MOSL) asked us to consider the benefits of aligning the Scottish retail market with the England and Wales market, and Consumer Scotland noted that actors in the retail market should have an opportunity to contribute to the SRC27 process. Consumer Scotland also asked to be included within the group of stakeholders of the non-household market.

### **WE DID**

In response to Consumer Scotland's request, we consider that a joint session on EBP&R and OBCR could be useful and will explore this further with stakeholders.

We have made several amendments to the methodology in response to Consumer Scotland's comments. For example, there is more emphasis on the importance of outcome measures covering all benefits that customers receive and mapping these measures to the Scottish Government's National Performance Framework (NPF). We have further highlighted the importance of Scottish Water partnering with customers, communities, and other agencies.

In response to the ICG's comment regarding future unforeseen circumstances, we have added further text to recognise the interim determination of charges (IDoK) process as a mechanism for dealing with factors outside of management control that arise during the regulatory period.

We are open to further engagement with MOSL, the Central Market Agency, and other key stakeholders to explore opportunities for cross-border alignment in the retail market, provided such changes align with our statutory duties. We have also amended the methodology to recognise Consumer Scotland's role in the non-household market.

## 1.3. Chapter 5: Principles for SRC27

### **CHAPTER INTRODUCTION**

Chapter 5 proposed that SRC27 be based on the following key principles:

- Embedding the principles of Ethical Business Practice and Regulation (EBP&R).
- A focus on high-quality evidence and analysis.
- Ensuring clear accountability.
- Building appropriate flexibility.

### **WE ASKED**

**Question 2: To what extent do you agree with the key principles outlined for SRC27?**

## YOU SAID

Scottish Water, Consumer Scotland, the Consumer Council for Water (CCW), the Drinking Water Quality Regulator for Scotland (DWQR) and Waterwise agreed with the key principles proposed for SRC27.

Consumer Scotland would welcome further consideration of what is needed to effectively monitor and provide insight into the effective application of the principles.

CCW particularly agreed with the principle of placing customers at the heart of the decision-making process and highlighted that this needs to be demonstrated and evidenced in our determinations. It suggested we could consider adopting the 'Your Water Your Say' online challenge sessions used during PR24 in England and Wales to enable consumers/interest groups to question Scottish Water and WICS' senior executives.

Waterwise noted the importance of evidence and analysis for water efficiency activities and of enabling flexibility.

## WE DID

In our final methodology, we have reflected that we will conduct some form of review following SRC27, which will also examine the extent to which the principles were followed and inform the approach to future strategic reviews of charges.

Regarding CCW's request that our determinations demonstrate and evidence that customers are placed at the heart of the decision-making process, the final methodology explains that an independent customer group has been created and tasked with examining how Scottish Water has used evidence from customer research to drive its decisions.

We welcome further discussion with CCW on its experience of customer engagement in England and Wales. To ensure that Scottish Water has ownership of its engagement on its plan, we will let them decide whether to extend the Annual Consultative Meeting format (which has some similarities to the 'Your Water Your Say' challenge sessions) to its business plan submission, as one mechanism to ensure wide engagement. We have added further text in chapter 8 of the final methodology to recognise this point.

## WE ASKED

**Question 3: Are there other relevant principles that should be considered? Why?**

## YOU SAID

### *EBP&R, OBCR and a collaborative approach among stakeholders*

Scottish Water welcomed and echoed our continued commitment to EBP&R and the collaborative approach stakeholders followed for the Scottish Government's policy development work. The ICG welcomed the central place of EBP&R and the customer voice. Scottish Water supported the focus on outcomes and asked to work together to understand the next step towards OBCR better.

### *Intergenerational considerations and a long-term context*

Scottish Water committed to ensuring that the key principles are at the heart of its business plan and that evidence and analysis are central to its investment decisions. Scottish Water considered that an additional important principle is providing intergenerational equity in its decisions, ensuring it appropriately balances short-, medium- and long-term investment. CCW suggested that section 5.5 could include a focus on the long-term context. It emphasised that a price determination should be placed within this context and should aim for a fair intergenerational balance of what customers pay now and in the future.

### *Transparency*

Consumer Scotland expressed the view that customers would benefit from greater transparency around the basis for charge increases. It highlighted that a more robust and transparent process is needed to provide customers with assurance and evidence that charges command the support of customers and communities. The ICG emphasised the importance of being transparent with customers, communities and other stakeholders around both:

- the need to invest in ageing assets and respond to the climate challenge; and
- the assumptions underpinning the need for real-term charge increases for the long term.

Consumer Scotland welcomed a requirement on Scottish Water to evidence that customers' and communities' views are reflected in all decisions. However, it highlighted the absence of a dedicated customer and community centric unit/team within Scottish Water makes it difficult to know how improvements in this area are being collated, coordinated, measured and monitored.

### *Outcome measures*

Consumer Scotland welcomed the opportunity to work with us to contribute to additional performance measures that support improved outcomes for customers and communities. It highlighted that this could include the measurement of consumer detriment resulting from Scottish Water's investment planning reducing or not prioritising investment to address known or recurring service-related issues such as surface water or sewer flooding. It also suggested considering measures that would support improved customer outcomes where none currently exist.

### *Flexibility*

DWQR noted it is critically important to allow sufficient flexibility in a risk (evidence) based approach to adapt it to emerging issues or new risks.

### *Considering the environment*

Waterwise emphasised that the environment should have a strong voice as well as the customer and suggested there could be a clearer emphasis that the environment must not suffer due to customer pressure. It also suggested that all infrastructure investment should demonstrate consideration and prioritisation of nature-based solutions.

## **WE DID**

### *EBP&R, OBCR and a collaborative approach among stakeholders*

In line with our earlier response to Consumer Scotland, we will seek to arrange a joint session between stakeholders on EBP&R and OBCR.

### *Intergenerational considerations and a long-term context*

We agree that intergenerational considerations are important. We have added a further principle on setting SRC27 in the context of the long term, recognising our statutory duties towards both current and future customers.

### *Transparency*

Consumer Scotland called for greater transparency on the basis of charge increases and a more robust, transparent process to provide assurance that charges command the support of customers and communities. In the final methodology (chapter 11 on the form of control), we have emphasised the expectation that Scottish Water will follow the assumed price profile in the Final Determination. If Scottish Water deviates from that profile, we expect them to set out the rationale for this (e.g. customers' views and investment requirements), the supporting evidence and to confirm that the proposed profile is consistent with Ministers' Principles of Charging.

### *Outcome measures*

On improved outcomes/further measures, we have amended the final methodology to further emphasise the importance of ensuring the outcome measures cover all benefits that customers receive, and that these measures are mapped to the Scottish Government's National Performance Framework (NPF). We consider that Scottish Water should identify whether there are gaps between outcome measures and the NPF and seek to fill these gaps.

The final methodology confirms that Scottish Water will need to propose its final outcome measures as part of its business plan, which should also take account of customer research and the composition of its proposed investment programme.

## *Flexibility*

Regarding DWQR's response, we have amended the final methodology to emphasise further the importance of flexibility in adapting to emerging issues or new risks.

### 1.4. Chapter 6: Scottish Water's SRC27 submission

#### **CHAPTER INTRODUCTION**

Our draft methodology indicated that we would require Scottish Water to prepare a business plan in the context of the water sector vision. This would include Scottish Water submitting a draft business plan by 12 June 2025 and a final business plan by 26 February 2026 reflecting the feedback received from us and other stakeholders on the draft plan.

We signalled that Scottish Water would have to explain in detail what the water sector vision means for the organisation. Its business plan would then indicate the progress Scottish Water will make towards delivering the water sector vision outcomes during 2027-33.

We indicated that the business plan should be evidence-based and set out:

- price profiles and assumed levels of borrowing;
- the allowed for level of investment;
- a forward-looking plan for investment projects and nature-based solutions;
- the outputs necessary to deliver or contribute to the outcomes in the water sector vision in the near term; and
- levels of service measures and annual commitments for those measures.

We asked that Scottish Water produce a delivery plan following the Final Determination, reflecting any amendments made to its proposals through the Final Determination. We also required that Scottish Water update its delivery plan each year to capture changes to the baseline from the Final Determination during the regulatory period.

#### **WE ASKED**

**Question 4: What further information could Scottish Water provide in its business plan?**

#### **YOU SAID**

Scottish Water supported our proposal for it to submit a business plan setting the six-year period in the context of its contribution to the sector's long-term vision. It emphasised the importance of reaching a common understanding on the approach to this, given that there are several pricing and investment trajectories and other uncertainties inherent in forecasting/planning for the next 25 years and beyond. Scottish Water indicated that its Long Term Strategy aims to help with this.

Consumer Scotland said it would welcome a clear commitment from Scottish Water to provide clear and transparent insight regarding deviation from planned investment/maintenance and its potential impact on service users. Consumer Scotland stated that greater transparency around any contingency to address changes in investment would provide assurance to key stakeholders.

The ICG signalled that it expects the business plan to demonstrate how customer priorities and views have been reflected in the plan.

CCW stated that the business plans in England and Wales have benefitted from the use of adaptive planning principles and that customer preferences could be incorporated into this modelling.

DWQR agreed with our proposed approach of asking Scottish Water to submit a business plan and ensuring that an adaptive investment planning approach is adopted. DWQR indicated that it expects the business plan to include an overview of the decision-making framework to be employed.

Waterwise asked that planned water efficiency activities and their expected outcomes over time be detailed clearly.

## **WE DID**

Regarding Consumer Scotland's response, the final methodology (chapters 6 and 14) confirms that we expect Scottish Water to produce a delivery plan each year after the Final Determination that captures changes to the baseline as agreed through the Scottish Government Investment Group (SGIG). As explained in chapter 15, the delivery plan will also allow Scottish Water to reflect the impact of any changes in the investment baseline on its forecast performance on its service measures. We have updated our approach in chapters 6, 14 and 15 to clarify that Scottish Water's delivery plans should explain this clearly and transparently.

In response to DWQR, the final methodology confirms that we are engaging with industry stakeholders to revise the process for defining the investment programme on a rolling basis and managing any changes. We expect further clarity on the revised process for SRC27 at the time of the final business plan submission (February 2026). We have further specified in the final methodology that Scottish Water's business plan should include an overview of the decision-making framework it plans to employ to develop the investment programme.

## **1.5. Chapter 7: Establishing confidence in Scottish Water's plan**

### **CHAPTER INTRODUCTION**

In chapter 7, we proposed the following approach for assurance:

- the Scottish Water Board providing a Board assurance statement with specific assurance on the areas that are most material to the outcome of the Strategic Review of Charges process; and

- placing further expectations for external assurance on the data and commentaries accompanying the business plan through co-designing an external assurance process.

We indicated that we would require Scottish Water to introduce the external assurance process for the annual return submission in 2024-25, recognising that this would be the final full year of information available when Scottish Water submits its final business plan (see the timeline in chapter 1) and to test the effectiveness of the approach.

We also proposed that we would establish our own arrangements in the event we consider it appropriate to commission our own review of specific aspects of Scottish Water's proposals.

## **WE ASKED**

**Question 5: Which key elements of Scottish Water's business plan would benefit most from assurance? Why?**

## **YOU SAID**

Scottish Water supported the proposal for a Board assurance statement setting out how it has assured the accuracy and completeness of the data and commentaries underpinning the plan and the co-design of an external assurance process.

Scottish Water did not support the use of a formal Reporter as it believes it could overlap and undermine its Board's role of approving an appropriate assurance approach.

Scottish Water suggested three elements would benefit most from external assurance:

- the data tables and accompanying commentary;
- its efficiency analysis; and
- the internal investment planning/asset management process it is adopting.

Scottish Water signalled it has begun developing its overall assurance process and using external experts to assure it is robust. Scottish Water committed to sharing its risk-based assurance plan and all external assurance with us.

Scottish Water explained that an assurance model with joint duty of care to Scottish Water and WICS would not be practicable. Instead, it proposed that we have a role in ensuring that any external assurer is suitably experienced, free of conflicts of interest, and understands the importance of impartiality.

The ICG stated that asset condition, innovation and efficiencies, and customer and community engagement should be specifically assured. It noted that customers need confidence that the evaluation of asset condition is robust and transparent given the impact that variations in the resulting investment can have on charging policy.

DWQR and CCW agreed with our proposed approach. DWQR welcomed the proposal for appropriate benchmarking of investment costs, stating that it expects external assurance in this area.

## **WE DID**

Through the bilateral assurance group established with Scottish Water, we have developed a Terms of Reference (ToR) for assuring the business plan data tables and commentary in a way which meets the requirements of both parties. We have further engaged with Scottish Water on the assurance of cost benchmarking and efficiency analysis. The ToR does not require the assurer to have a joint duty of care. Instead, it emphasises that it is essential for the assurer to be completely impartial in their review of the business plan and free of conflicts of interest. We will also be involved in the selection process of the independent assurance provider. We also retain the option of conducting our own independent assurance if we do not have confidence in the assurance provided. We have updated the final methodology approach in chapter 7 to reflect these points.

In response to the ICG, we recognise the importance of Scottish Water demonstrating the impact of its maintenance activities on its asset base. Our business plan guidance and data tables include asset condition measures. Scottish Water has recognised that further work is required in this area. We agree and have reflected in the final methodology that assurance on asset condition and plans for improving the quality of information and addressing gaps would be valuable. We are also engaging with Scottish Water on their approach to assuring the business plan, including assuring the reasonableness of their investment demand forecasts.

Regarding DWQR's response, we have amended the final methodology (chapter 14) to reflect the developments in this area, e.g. external benchmarking of cost models. We have also indicated in the final methodology that we are engaging with stakeholders to develop arrangements for receiving external assurance on the size of the investment programme that can be delivered efficiently.

## **1.6. Chapter 8: Customer engagement**

### **CHAPTER INTRODUCTION**

Our draft methodology indicated that we would place full ownership on Scottish Water to develop its business plan and demonstrate that customers' priorities are appropriately reflected. By extension, this will ensure that our Final Determination of charges commands the support of customers and communities.

Our proposed approach would involve setting out clear expectations on Scottish Water to work openly and collaboratively with both Consumer Scotland and WICS on the following:

- Design and development of customer research through a multi-stakeholder research coordination group. This would include undertaking longitudinal, deliberative research to understand strategic prioritisation and customers' acceptability of the business plan.
- Establishment of a Customer Challenge Group that would provide additional assurance on the quality of Scottish Water's engagement and research, and the extent to which customer priorities and research is reflected in Scottish Water's business plan.

We also signalled our intention to introduce a tripartite agreement between WICS, Scottish Water and Consumer Scotland setting out the principles and programme of joint work on customer engagement. These principles would include legitimacy, empowerment, challenge, and collaboration. We expected this agreement to be finalised for our final methodology.

## **WE ASKED**

**Question 6: Do you support our proposed approach on customer engagement? Why?**

## **YOU SAID**

### *Memorandum of Understanding and principles for customer engagement*

Scottish Water noted that it has prepared a Memorandum of Understanding (MoU) on customer engagement for SRC27 with Consumer Scotland and WICS. Consumer Scotland welcomed this joint effort to establish a MoU. Four Principles for Customer Engagement in SRC27 were agreed upon: Empowerment, Credibility, Collaboration, and Independent Challenge. Scottish Water committed to embedding these Principles in its Evidence, Challenge, and Confirmation pillars of work to ensure customers will be at the heart of SRC27.

### *Independent Customer Group*

Consumer Scotland considers the Independent Customer Group's (or ICG, which is the name given to the Customer Challenge Group) role within SRC27 in undertaking the 'Challenge' pillar is important for ensuring that Scottish Water takes proper account of consumer research and puts the consumer voice at the heart of SRC27. Consumer Scotland noted it has worked with Scottish Water to put in place a special Terms of Reference (ToR) for the ICG during SRC27.

### *Customer research*

Consumer Scotland welcomed the emphasis on the benefits of deliberative research and highlighted that it will commission such research. The ICG welcomed the commitment to putting customers and communities at the heart of the process and emphasised that research is required to ascertain their views. CCW agreed with Consumer Scotland's intention to use independent customer research to test the Draft Determination.

### *Customer, community and wider engagement*

Consumer Scotland would welcome greater emphasis on the need for meaningful community engagement in alignment with the 'place principle'.

The ICG identified a need to explore approaches to engaging with business end users. Similarly, Market Operator Services Limited (MOSL) encouraged Scottish Water and WICS to ensure that non-household customers are fully factored into the customer engagement approach.

CCW believes Consumer Scotland's approach will help ensure Scottish Water engages well with its customers and communities. It emphasised that this requires WICS to show how the evidence from this process will be used and how the regulator will consider stakeholder challenges to the business plan.

CCW shared some of its experience in customer engagement in England and Wales. It listed the requirements of an independent Customer Group that can help ensure company proposals are scrutinised and challenged. CCW requested that WICS be clear about the requirements of the group and what it can meaningfully influence. CCW also suggested the introduction of Customer Panels for different regions of Scotland and would be happy to discuss this further with WICS.

Waterwise deemed the customer engagement approach appropriate for developing the plan but suggested that customer engagement should be ongoing and allow customers to challenge Scottish Water's performance. Waterwise requested that the final methodology be clearer on opportunities for wider stakeholder engagement and proposed renaming the CCG the Independent Challenge Group.

## **WE DID**

### *Memorandum of Understanding and Principles for Customer Engagement*

The final methodology confirms the agreement of the MoU among the three organisations (Consumer Scotland, Scottish Water and WICS).

### *Customer, community and wider engagement*

We have amended the final methodology following Consumer Scotland's response to recognise the importance of Scottish Water considering both communities of interest and place.

In response to the ICG and MOSL, we have amended the final methodology to highlight the need for Scottish Water and its ICG to explore approaches to engaging with business end users.

We would welcome further discussion with CCW on its experience of customer engagement in England and Wales, including on the use of Customer Panels.

Following Waterwise’s response, we have amended the final methodology to clarify that we expect Scottish Water to engage with wider stakeholders throughout the development of its business plan.

## **WE ASKED**

**Question 7: Do you have any further views on chapter 8?**

## **YOU SAID**

Scottish Water requested that the final methodology reflect the elements in the three pillars of the MoU. Scottish Water indicated that the Challenge pillar will require the ICG to use evidence to challenge Scottish Water to put customers’ needs and expectations at the heart of its business plan. To facilitate this, Scottish Water and Consumer Scotland agreed a Terms of Reference for the ICG for SRC27. Scottish Water noted that the ICG would produce an assurance report commenting on how well Scottish Water engaged with customers/communities and reflected their insights in its business plan.

## **WE DID**

The final methodology confirms the agreement of the MoU among the three organisations.

# 1.7. Chapter 9: Core and non-core activities

## **CHAPTER INTRODUCTION**

Our draft methodology proposed updating the current regulatory accounts to document which activities are core and non-core and clarify the revenues, costs and level of risk in each category. This would involve working with Scottish Water to develop a list of questions to help categorise activities as core or non-core and determine the appropriate allocation of revenues and costs.

We proposed applying these principles to all activities except those involving its subsidiary Business Stream and using the same questions to agree on whether new activities undertaken by Scottish Water in the future should be documented as core or non-core in the regulatory accounts.

## **WE ASKED**

**Question 8: Do you have any views on our proposals to provide further clarity on the definition of core and non-core activities for the purposes of our regulation?**

## **YOU SAID**

The ICG and CCW agreed that there is a need for clarity between core and non-core activities. Scottish Water said it was supportive of and engaged in the review of the Regulatory Accounting Rules (RARs), which will help draw this distinction.

Scottish Water explained that it always ensures it meets its existing duty under the 1998 Competition Act to ensure that there is no cross-subsidy or abuse of a dominant position and clarified that Business Stream is very much removed from the regulated entity. It expressed confidence that Horizons operates in a manner that ensures compliance with the Competition Act.

Consumer Scotland recognises that Section 29e in the Water Industry (Scotland) Act 2002 needs to be updated. Consumer Scotland said they would welcome a greater commitment from Scottish Water to work with businesses and licensed providers to identify where the cost to serve can be reduced by alleviating pressure on assets.

## **WE DID**

The final methodology confirms our approach to ensuring a clear distinction between core and non-core activities, and we welcome Scottish Water's engagement in the review of the RARs.

In response to Consumer Scotland, we confirm that Scottish Water is expected to partner with others to find better solutions for customers and the environment. We recognise that Section 29e provides one such mechanism for Scottish Water to work in partnership with businesses and licensed providers and set this out in section 14.3. Further updates to Section 29e would need to be considered through Scottish Government's policy development for the water industry.

## 1.8. Chapter 10: Balancing costs between current and future customers

### **CHAPTER INTRODUCTION**

In setting charge caps, we proposed continuing to target and monitor Scottish Water's financial strength using financial ratios. We also proposed using a shadow regulatory capital value for Scottish Water to allow for comparability with companies in England and Wales.

Regarding asset maintenance expenditure, and in line with our statutory duty to promote the interests of both current and future customers, we proposed continuing transitioning charges to reflect the full level of economic depreciation.<sup>1</sup> During this transition, there would be an accumulated shortfall (or increased deficit/liability) based on the difference between economic depreciation and the cash available for asset maintenance. We asked that Scottish Water report this liability annually.

The Commissioning letter asks that our Draft Determination set out a range of possible charge paths. As such, we set the expectation that Scottish Water explains the implications of each charge path

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<sup>1</sup> We define economic depreciation as the average annual level of replacement consistent with replacing assets at their end of life and maintaining services in perpetuity.

on the length of time it will take to transition to recover the full economic depreciation in charges and the resulting replacement deficit from the proposed charging levels.

Our proposed approach for SRC27 required Scottish Water to continue improving its understanding of long-term asset replacement costs. As part of the investment baseline, we also asked Scottish Water to set out the maintenance expenditure it plans to deliver throughout the 2027-33 period. This would include explaining what measurable outputs would be delivered across different asset categories and the impact this would have on the underlying condition of the asset base. The medium- and long-term consequences of not making this investment should also be clear and measurable.

## **WE ASKED**

**Question 9: Do you have any views on our proposals in relation to balancing the costs between current and future customers?**

## **YOU SAID**

Consumer Scotland and CCW raised the importance of managing the risk of Scottish Water's future borrowing arrangements. Scottish Water welcomed our proposed ratios to measure its financial strength and asked for further engagement with us regarding its long-term asset replacement models.

Consumer Scotland asked for confirmation that the split between domestic and non-domestic usage is still approximately 70:30, highlighting that consumption trends may have changed post COVID-19.

The ICG highlighted the importance of transparency on the cost of the transition to economic depreciation being reflected in customer charges, the effect of different transition trajectories, and what account is taken of technological advances which could reduce replacement costs.

DWQR noted the need to implement a robust decision-making framework that is aligned with the agreed risk appetite. They also noted that where an investment is not to be delivered, provision for the operational mitigation of risk may be required.

## **WE DID**

We recognise the importance of analysing Scottish Water's financial strength and will continue to assess its ongoing ability to service its debt.

In response to Consumer Scotland, we have added further text in the methodology to explain that we expect Scottish Water's business plan to set out where any rebalancing is required if they consider that charges do not reflect the cost of serving different customer groups.

In response to the ICG, we confirm in chapter 10 of the methodology that Scottish Water's different charge paths should:

- set out the progress it expects to make towards delivering the Objectives of Scottish Ministers;
- show the proposed level of investment and implications on levels of risk and the impact on future service levels; and
- show the difference between the sustainable level of economic depreciation and actual replacement expenditure on a cumulative basis.

In response to DWQR, we have added further text to chapter 6 to specify that an overview of the planned decision-making framework should be included in Scottish Water's business plan. We are also engaging with stakeholders to revise the process for defining the investment programme on a rolling basis and managing any changes. We expect to have further clarity on what the revised process will look like for SRC27 at the time of the final business plan submission (February 2026).

## 1.9. Chapter 11: Form of control

### CHAPTER INTRODUCTION

Our draft methodology proposed setting a cumulative real charge cap over the six-year period, similar to the approach adopted in SRC21.

The additional flexibility associated with a cumulative cap for the period could result in some variations in the cash available over the period compared to the Final Determination, depending on the annual profiling of charges. For this reason, we signalled that if, at any point during the regulatory period, Scottish Water were to apply a charge profile different to that assumed in the Final Determination, we would require Scottish Water to explain the short- and long-term implications of the difference (e.g. a result of front-loading versus end-loading price changes).

We also indicated that we would be open to considering an alternative proposal if Scottish Water's customer engagement and research programme identified a clear preference for an alternative approach.

### WE ASKED

**Question 10: Do you have any views on our proposed form of control?**

### YOU SAID

Scottish Water noted its limited flexibility to recover funding in the last period following below price cap charge increases, which affected the funding available to meet the level of investment consistent with the Ministerial Objectives. An alternative form of control was proposed, which they believe would provide greater flexibility to re-profile charges through SRC27 while maintaining the level of investment consistent with the Ministerial Objectives.

The ICG noted that the form of control should protect customers from excessive increases in charges while allowing Scottish Water to cover necessary operational and capital costs. The pricing mechanism should take into account inflationary pressures and the need for investment, but it should also keep customer affordability as a priority.

CCW noted that customer engagement could show a preference for an alternative model and supported our proposal that customers could inform the form of control.

## **WE DID**

We have considered Scottish Water’s proposed approach. While their proposal might provide Scottish Water with more certainty over the total revenue available to meet Ministerial Objectives, our view is that this could leave customers with potentially volatile changes in charges. Therefore, we do not consider that such an approach would be consistent with the principles of ‘Stable charges’ and/or ‘Fair, equitable and affordable charges’ as set out in the initial draft Principles of Charging provided in Annex C to the Commissioning letter.<sup>2</sup>

We recognise the broader consideration of ensuring Scottish Water has the funding available to meet the Ministerial Objectives. In response, we have emphasised in chapter 11 the expectation that Scottish Water follows the assumed charge profile in the Final Determination. If Scottish Water deviates from that profile, we expect them to set out the rationale for this, provide supporting evidence, and confirm that the proposed profile is consistent with the Ministers’ Principles of Charging.

## 1.10. Chapter 12: Cost assessment

### **CHAPTER INTRODUCTION**

Our draft methodology set out our intention to collect information and assess the efficient level of expenditure over the period at a disaggregated level. We indicated that we would use the following expenditure categories:

- Operating costs
- PFI costs
- Interest
- Taxation
- Repairs
- Refurbishment
- Asset replacement
- Enhancement
- Growth
- Reasonable costs contributions (RCCs)

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<sup>2</sup> The Commissioning letter explains that the Principles of Charging for the 2027-33 regulatory period will be an evolution of those that currently apply during the 2021-27 regulatory period, and Ministers request that the Commission takes these as their starting point with minor amendments. These were provided in Annex C of the Commissioning letter. The Commissioning letter explains that Ministers will consult on their draft Principles of Charging during 2025.

Furthermore, we proposed using expenditure from 2024-25 as a base-year and price base (based on financial year average) for the 2027-33 regulatory period.

## **WE ASKED**

**Question 11: Do you have any views on our proposals in relation to cost assessment?**

## **YOU SAID**

Scottish Water welcomed our proposed approach to cost assessment, and agreed on the importance of understanding potential efficiency sources within each cost category. They proposed separating out investment in climate change adaptation from that in asset replacement, enhancement, and growth. Scottish Water also suggested that setting efficiency at a more aggregated level would incentivise optimal decision making within Scottish Water.

Scottish Water agreed in principle that 2024-25 is an appropriate price base for SRC27. However, they did propose a 2023-24 price base for the draft business plan to allow internal and external stakeholders to relate to more up-to-date numbers. Scottish Water would then move to a 2024-25 price base for its final business plan.

## **WE DID**

The final methodology and business plan guidance explains that responding to the effects of climate change should be fully embedded in how Scottish Water develops its investment programme. Therefore, investment in climate change adaptation should feature across the different categories of Scottish Water's investment: enhancement, growth and maintenance. However, the final methodology also recognises there are merits in separately identifying climate change adaptation as a driver within each category, recognising that it is likely to be a material driver of investment in the future. As such, chapter 14 in the final methodology explains that Scottish Water should identify investment associated with climate change adaptation through a secondary category within each area.

The final methodology confirms the approach of disaggregating expenditure into ten categories and estimating the scope for efficiency at a more disaggregated level than SRC21. However, we would welcome Scottish Water's proposals for how the scope for efficiency could be applied at a more aggregate level.

We agree with Scottish Water's price base proposal and have reflected this in the final methodology and business plan guidance.

### 1.11. Chapter 13: Operating expenditure

## CHAPTER INTRODUCTION

Our draft methodology proposals for SRC27 focused on step changes in operating and Private Finance Initiative (PFI) expenditure and the underlying operating efficiency challenge.

### *Step changes in operating and PFI expenditure*

We expect there will be step change increases and decreases from the reported operating expenditure in 2024-25 due to:

- the expiry of PFI contracts;
- Scottish Water adopting operating-based solutions rather than capital solutions to deliver improvements; and
- spend-to-save and transformation initiatives, where appropriate.

We requested that Scottish Water provide forecasts for operating expenditure in each of these areas for the six-year period. We then set out expectations for supporting evidence for each area.

### *Underlying operating efficiency challenge*

We indicated that Scottish Water should exclude operating expenditure for operating-based investment solutions from the efficiency assessment, as their inclusion could discourage Scottish Water from pursuing such initiatives.

We set an expectation that Scottish Water adopts different techniques and comparators, including making greater use of benchmarking against the performance of the companies in England and Wales. For catch-up efficiency, we asked that Scottish Water begin by applying the following models:

- the base expenditure models used by Ofwat for its 2019 price review (as updated by the Competition and Markets Authority); and
- the base expenditure models used by Ofwat in PR24.

We requested that Scottish Water propose amendments to the models in two areas - capital maintenance and PFI contracts - to ensure consistent benchmarking.

We also signalled that Scottish Water should evidence the scope for frontier-shift efficiency improvements over the six-year period.

We required Scottish Water to provide an efficiency plan that sets out:

- how it will evidence and demonstrate its approach to assessing its efficiency challenge;
- the extent of the overall efficiency challenge; and
- how it proposes to achieve it.

## **WE ASKED**

**Question 12: To what extent do you agree with the proposed approach to assessing Scottish Water's efficiency?**

## **YOU SAID**

Scottish Water and DWQR agreed with our proposed approach to assessing Scottish Water's efficiency.

## **WE DID**

We confirmed our approach to assessing Scottish Water's efficiency in the final methodology.

## **WE ASKED**

**Question 13: Do you have any further views on chapter 13?**

## **YOU SAID**

Consumer Scotland and the ICG supported partnership working between Scottish Water and customers. These stakeholders also noted that consumers could have more information on what actions they should take. Consumer Scotland suggested a "whole society" approach.

Scottish Water broadly agreed with our approach for assessing operating expenditure (OPEX), and noted they are preparing a proposal for efficiency assessment that will cover both operational and capital expenditure. Scottish Water proposed that the overall OPEX efficiency challenge for SRC27 could be formed of a catch-up efficiency challenge and an appropriate frontier-shift challenge, and requested further discussion of adopting a total expenditure (TOTEX) level efficiency challenge.

Scottish Water suggested that it also provides details on specific spend-to-save and transformation initiatives in its initial and subsequent delivery plans. It indicated that it would bring these to the Scottish Government Investment Group (SGIG) for discussion and approval where appropriate.

Scottish Water suggested that the evidence it has met the requirements of our SRC21 Final Determination would be best delivered through its reporting in the annual return. They also welcomed the recognition of the cost uplift pressure due to returning PFI assets.

DWQR noted that alternative investment options must be considered alongside a risk-based approach because they may not always address a significant risk to drinking water quality as effectively and as quickly as necessary.

## **WE DID**

We received Scottish Water's efficiency proposals in October 2024, and we will continue to engage with Scottish Water on its approach to assessing operating and capital efficiency. We welcome that Scottish Water's proposed approach aligns with our expectations from the draft methodology.

Regarding transformation, we have provided a table<sup>3</sup> that sets out the information we will require from Scottish Water as these opportunities are identified. We expect Scottish Water to populate this table on an ongoing basis during the regulatory period as part of its initial and subsequent delivery plans. However, if there are any relevant initiatives that Scottish Water is aware of at the time of the business plan submission, we request that it provide this information in the table for those initiatives as part of its business plan submission. We also request that Scottish Water provide its overall approach to transformation in narrative form in its business plan submission. We have updated the final methodology to reflect these points.

The final methodology clarifies that past delivery is an important factor in considering the efficiency challenge for SRC27 in the round. As such, we consider that Scottish Water's performance to date in meeting the requirements of the SRC21 Final Determination should be covered in Scottish Water's SRC27 business plan submission in addition to the annual return submission.

## 1.12. Chapter 14: Investment

### CHAPTER INTRODUCTION

In our draft methodology, we indicated that we would expect Scottish Water to translate the Scottish Ministers' Objectives and its contribution to the outcomes of the water sector vision into specific service measures and annual commitments. SRC27 would require Scottish Water to develop an investment programme to meet these commitments.

Our proposed approach for SRC27 recognised that Scottish Water's investment would be at different stages of maturity and tailored our approach for reviewing the investment accordingly.

- For investment at an early stage of development (pre-development stage in the investment planning process), we indicated that we would test the reasonableness of Scottish Water's assumptions for indicative costings and outputs and conduct high-level benchmarking.
- For investment that is more developed or underway, we signalled that we would request standard information for projects in excess of £3m and programmes of work.<sup>4</sup> This information would include forecast costs, outputs, interim milestones and milestones for projects post commitment. We indicated that we would also require Scottish Water to clearly set out the completion investment and the source of funding for this investment, to ensure that customers receive the benefits they have paid for.

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<sup>3</sup> Table 6 of the Business Plan guidance and data tables.

<sup>4</sup> We define a programme as comprising investment that share the same characteristics, involves the delivery of the same group of investment outputs, involves repeatable work of similar construction requirements and risk profiles and the location of the investment is not known.

We signalled that we would use this information to evaluate the efficiency of Scottish Water's proposals and set an investment baseline in the Final Determination. We recognised that the scope and cost of some investment projects may change as they progress through the investment planning process. We indicated that we would use the Final Determination investment baseline as a reference point for reviewing the investment progressing through the revised governance process on a rolling basis.

We indicated that we consider a good outcome for SRC27 is to improve stakeholder's understanding of Scottish Water's asset base and the impact of Scottish Water's maintenance activities on that asset base, including measuring asset condition.

We proposed two key changes to the investment planning process to meet our requirements and to address the requirement in the Commissioning letter for a suitable governance structure to be developed which identifies, on a rolling basis, the outputs necessary to deliver their Objectives:

- To support our monitoring of Scottish Water's performance, we would ask Scottish Water to produce a delivery plan showing how it proposes to meet the requirements of the Final Determination and an annual delivery plan refresh before each financial year, which captures the changes to the investment baseline.
- An additional step in the investment planning process when a project is in development, which would involve us reviewing the efficiency of Scottish Water's proposed investment. We proposed to review a sample of projects or specific projects that stakeholders consider merit a review.

## **WE ASKED**

**Question 14: To what extent do you agree that our proposals provide the required level of flexibility for Scottish Water's investment programme, while ensuring that Scottish Water remains accountable for delivery?**

## **YOU SAID**

Scottish Water agreed and DWQR strongly agreed that our proposals provide the required level of flexibility for Scottish Water's investment programme, while ensuring that Scottish Water remains accountable for delivery.

Consumer Scotland highlighted the benefits of greater community engagement in the pre-planning and design process of capital investment projects. It welcomed that this is being applied within Scottish Water's appraisal process and expressed support for its ongoing maturity.

CCW agreed with our proposals, provided that the outcomes that people need are delivered within the expected timescales.

## **WE DID**

We confirmed our approach in the final methodology.

## **WE ASKED**

**Question 15: Do you have any further views on chapter 14?**

## **YOU SAID**

Scottish Water, DWQR, and the ICG supported the level of flexibility we proposed. DWQR welcomed the flexibility to address changing requirements but also sought acknowledgement that in certain situations, there may be less scope for flexibility, and a firm commitment to delivery may be required.

Scottish Water and the ICG recognised there may be a tension between flexibility and monitoring. Scottish Water welcomed further discussion on the approach to proposing, agreeing, and reporting on changes to the original investment baseline during the regulatory period. The ICG advised that a 'whole system' approach should still be maintained.

Regarding customer engagement, CCW requested that Scottish Water demonstrate that it has engaged with its Challenge Group when optioneering. The ICG set out its expectations that customers' views will be incorporated into the formal review of the investment framework.

Scottish Water recognised the occasional need to assess programmes/projects using external experts; however, they would prefer a partnership with WICS in order to limit duplication of work. They also indicated that they are preparing a proposal for efficiency assessment that will cover both operational and capital expenditure. Their final note was that the thresholds for Project Investment Appraisal (PIA) have increased.

## **WE DID**

We agree with DWQR that in some cases Scottish Water may have less flexibility in deciding how and when to deliver investment outcomes. We have amended the text in the final methodology to acknowledge this.

In the final methodology, we confirm our approach to demonstrating customer engagement. In response to the ICG, we confirm that we are engaging with industry stakeholders to revise the process for defining the investment programme on a rolling basis.

We would look to avoid unnecessary duplication of work with Scottish Water whilst also noting that in performing our statutory functions, we require the ability to conduct our own reviews of Scottish Water's proposals, if necessary. We will continue to engage with Scottish Water on their approach to assessing operating and capital efficiency.

Scottish Water explained it has recently reviewed these cost thresholds. As these were set in 2008, Scottish Water has decided to double the existing thresholds to reflect construction price inflation and its improvements in programme management governance. To reflect these changes, Scottish Water has increased the threshold for projects that receive the highest level of investment appraisal from £3m to £6m. We explain in chapter 14 that this threshold change will not significantly impact our ability to review the investment programme and investment cases in more detail. We set out the standard information that we require for all programmes of work to ensure visibility of the full investment programme.

## 1.13. Chapter 15: Levels of service

### CHAPTER INTRODUCTION

Our draft methodology set out that Scottish Water's levels of service measures must demonstrate its progress in delivering the Objectives of the Scottish Ministers as an important step in the journey towards achieving the sector vision. We set the expectation that Scottish Water translates its contribution towards the high-level outcomes from the sector vision into tangible measures and milestones over the long term.

Scottish Water would then be expected to prepare a business plan showing how it plans to meet the Statement of Objectives for the 2027-33 regulatory period. As part of this, we considered that Scottish Water has scope to align some of its existing performance and asset measures with those in place in England and Wales to enable benchmarking. We emphasised the importance of Scottish Water understanding customer priorities through research when establishing measures and setting targets. We set out our intention to work with DWQR to identify the scope for benchmarking drinking water quality measures between Scotland and England and Wales.

We signalled that as part of its business plan, we would require Scottish Water to set annual targets on its performance measures where applicable, taking account of its proposed investment programme and historic performance.

We indicated that we were developing a template outlining areas that could be covered by performance measures to serve as an initial view for further discussions with Scottish Water. We considered that in developing measures and setting targets, Scottish Water should commit to a set of principles, including, but not limited to:

- The measures should align with both the outcomes outlined in the Scottish Ministers' Objectives and the outcomes Scottish Water is expected to deliver as part of the water sector vision to help track progress towards achieving the water sector vision.
- The annual targets should be stretching while maintaining the incentive for outperformance.

We considered that our requirement for a delivery plan and the annual refresh of the delivery plan could allow Scottish Water to reflect the impact of any changes in the investment baseline on its forecast performance of its levels of service measures.

## **YOU SAID**

### *Performance measures and targets*

Scottish Water supported a review of service measures. It considered that targets should only be applied to those areas that materially impact its customers and the service they receive. It also noted there may be justification for broader performance measures, e.g. regarding its effectiveness in maintaining its assets or managing financial risks.

### *Demand reduction and smart metering*

Business Stream cautioned against fully aligning with Ofwat's PR24 approach to demand reduction and smart meter rollout.

- Demand reduction: Business Stream advocated for promoting water efficiency and improving demand-side leaks in the non-household sector. It agreed that a per capita consumption incentive would not be appropriate for SRC27, but noted this should not prevent raising funding in a proportionate manner to support customers' water efficiency initiatives. It highlighted that the key considerations would be how the funding is used and who has access to it in a way that benefits the environment and customers and supports market competition.
- Smart metering: Business Stream requested that the cost assessment approach accounts for the diversity of non-household customers and provides incentives to prioritise those who would benefit most from smart meters.

### *Water efficiency, demand and consumption*

Waterwise highlighted the need to be clearer on the language used around water efficiency and targets in section 15.3 of the draft methodology, especially on per capita consumption. It noted there are many things a water company can do to help reduce water demand and per capita consumption. Waterwise suggested that Scottish Water's plan should indicate the future levels of demand anticipated through to at least 2055, and how this will be met. It also stated that Scottish Water should set out the levels of leakage, household and non-household consumption it is planning around and the measures planned to reach those levels. This can then be used to check annually whether the company is on track.

## **WE DID**

### *Performance measures and targets*

We consider that Scottish Water should provide its forecast performance on each measure over the regulatory period. Scottish Water should then identify which of the forecasts represent targets

against which it will be held accountable for delivering to customers over the regulatory period as part of the regulatory contract. We also note that Scottish Water can propose additional outcome measures as part of its business plan submission. The final methodology confirms our approach to service measures and the set of principles that Scottish Water should follow in finalising these.

#### *Demand reduction and smart metering*

In response to Business Stream, our business plan guidance and data tables include a business demand measure. We will review Scottish Water's proposals for smart metering either as part of its business plan submission or through the investment planning and prioritisation process.

#### *Water efficiency, demand and consumption*

Regarding Waterwise's response, we have asked Scottish Water to provide forecasts for per capita consumption, which we will monitor during the period. We have amended the final methodology to further emphasise the importance of understanding per capita consumption and confirm that the per household consumption measure is currently reported and monitored annually.

## Appendix 2 – Overview of the water industry in Scotland

This appendix provides further background information on the water industry in Scotland.

### SCOTTISH WATER

Scottish Water is responsible for providing water services to around 2.6 million households and wastewater services to around 2.5 million households, which covers 98% and 94% of the Scottish population respectively.<sup>5</sup> The remaining customers are served through other arrangements, namely private water supplies in relation to water services and septic tanks in relation to wastewater services. Scottish Water charges most households for wastewater and drainage services under a single wastewater charge.<sup>6</sup>

Scottish Water is a publicly owned organisation. This means that it is answerable to the Scottish Parliament and the people of Scotland through the Scottish Ministers.

### SCOTTISH GOVERNMENT

The Scottish Government plays a central role in the water industry. It has three distinct roles:

- owner of Scottish Water;
- setting policy; and
- lender to Scottish Water.

Each role is covered below.

#### *Owner*

The Scottish Government acts as the owner of Scottish Water. They appoint the Non-Executive members of the Board.

#### *Policy maker*

The Scottish Government sets the overall policy for the water industry through Ministerial Objectives and Principles of Charging. The approach to policy in the Strategic Review of Charges (SRC) is covered in detail in section 3.3.

As explained in section 4.4, the Scottish Government is undertaking work to develop policy for the water industry.

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<sup>5</sup> See section A of Scottish Water's annual return for 2023. The percentage of the population connected to water and wastewater is based on Scottish Water's reported population in section A, table A4 divided by the latest estimate of the total population of Scotland reported by the National Records of Scotland of 5,447,700 in mid-2022. National Records of Scotland (2024), 'Mid-2022 Population Estimates', webpage.

<sup>6</sup> Around 400 out of the 2.5 million households served pay separately for drainage services (see section P of Scottish Water's annual return for 2023).

### *Lender to Scottish water*

Finally, the Scottish Government acts as the lender to Scottish Water. Scottish Water can borrow up to a limit set by the Scottish Government in the Principles of Charging.

## **OVERVIEW OF WICS**

The Water Services etc. (Scotland) Act 2005 established the Water Industry Commission for Scotland (WICS) as the economic regulator of Scottish Water. WICS is a non-departmental public body with an independent Board.

Fulfilling the duties set out for WICS in the 2005 Act involves three main activities:

- setting caps on charges for household customers and on wholesale charges for retailers (known as licensed providers) that serve non-household customers;
- monitoring Scottish Water's performance against the forecasts made at the time of setting charge caps; and
- overseeing the orderly functioning of the non-household retail market in Scotland.

Each activity is covered in turn below.

### *Setting charge caps*

WICS sets caps on charges for household customers and wholesale charges for licensed providers through a multi-stakeholder, transparent and consultative process known as the SRC. The SRC is set out in more detail in chapter 3.

### *Monitoring Scottish Water's performance*

WICS closely monitors the performance of Scottish Water. It publishes an annual assessment of Scottish Water's performance.<sup>7</sup>

WICS assesses Scottish Water's performance in several key areas, including the quality of the service provided to customers, whether Scottish Water is on track in delivering the investment needed to maintain and upgrade its asset base, and the level of operating costs incurred in the year.

Underpinning the assessment of Scottish Water's performance is the annual return, an annual information submission by Scottish Water to WICS which provides data and associated commentary on various aspects of Scottish Water's performance. WICS reviews each annual return in detail to ensure the information is of high quality.

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<sup>7</sup> WICS (2024), 'Scottish Water's Performance 2022-23', 7 March 2024.

### *Overseeing the functioning of the non-household retail market*

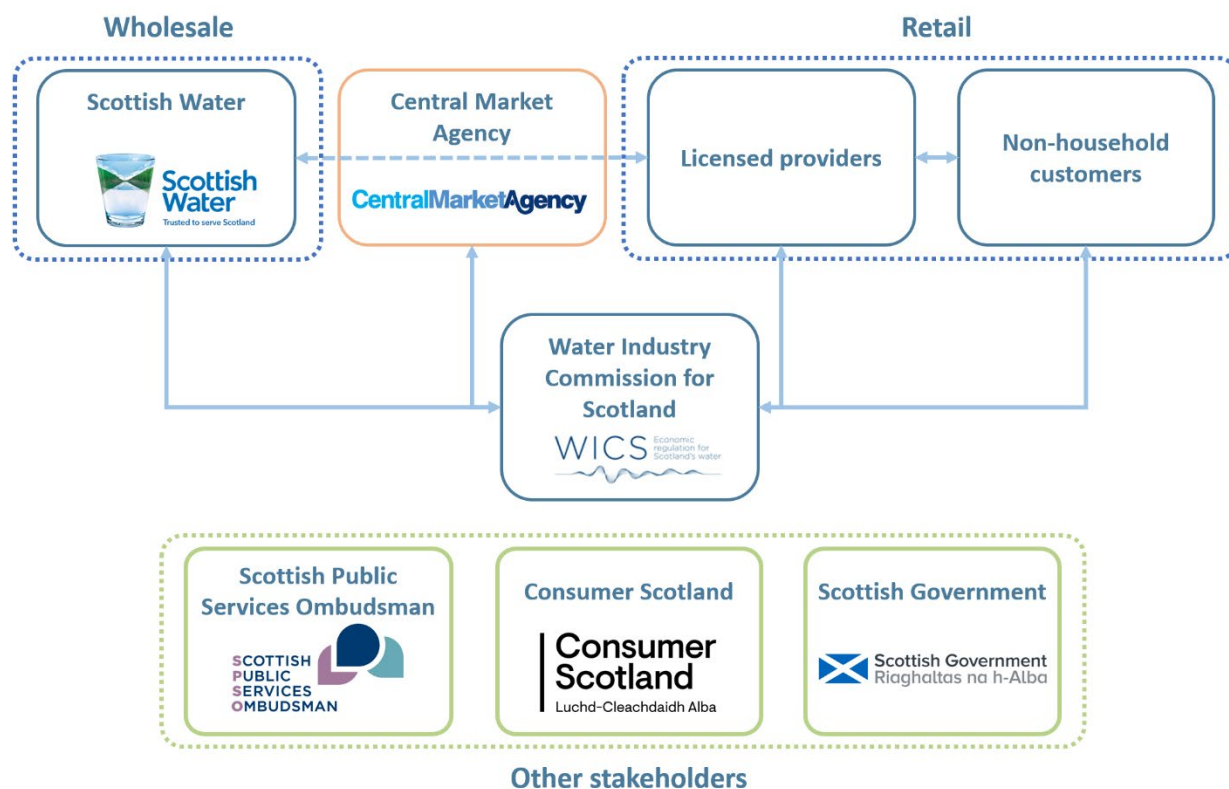
The Water Services etc. (Scotland) Act 2005 introduced a retail market in Scotland in April 2008 by opening the non-household water and sewerage market up to competition, allowing non-household customers to choose their licensed provider. These non-household customers comprise businesses, industrial users, public sector organisations and charities. The market participants are as follows:

- **Scottish Water** continues to operate and maintain the water and wastewater network and provides wholesale services to licensed providers.
- **Licensed providers** are responsible for performing the retail functions for which they are licensed<sup>8</sup> and are required to comply with a suite of market codes and licence requirements. Licensed providers are responsible for collecting water, sewerage (standing, volumetric and any unmeasured charge where a meter cannot be installed) and drainage charges (where applicable) from non-household customers, and remain liable for these charges to the wholesaler, Scottish Water.
- These **non-household customers** comprise businesses, industrial users, public sector organisations and charities.
- The **Central Market Agency (CMA)** administers the retail market systems used by Scottish Water and licensed providers on a daily basis. This includes information regarding meter readings, transfer requests and the non-household customers registered to each licensed provider in Scotland. The CMA also calculates the wholesale charges that licensed providers owe Scottish Water.
- **Consumer Scotland**, whose advocacy role in the water sector in Scotland also covers embedding positive consumer outcomes for small businesses in the non-household water market.
- **WICS** oversees the orderly functioning of the non-household retail market.

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<sup>8</sup> Retail services are limited to customer-facing activities such as meter reading, managing billing and payment arrangements, bad debt management, and customer enquiries and complaints. Some retailers offer additional value-added services such as advice on water efficiency and management of wastewater discharges.

Figure 1: Overview of the non-household retail market



As shown in Figure 1, WICS interacts with all stakeholders of the retail non-household market throughout the supply chain.

The 2005 Act gave WICS the power to grant licences to new retailers that wish to supply non-household customers in Scotland and to revoke existing licences. WICS' licensing powers are limited by an obligation to encourage orderly participation in the market in a manner that is not detrimental to Scottish Water's core functions. WICS also monitors the compliance of licensed providers with their licence conditions and is responsible for ensuring market arrangements support a level playing field.

In order to protect customers, WICS requires licensed providers to provide non-household customers a set of default services to a particular standard (the default standards) at a price no higher than the default maximum tariff (regardless of their location or the size of their business). Default tariffs are set annually by WICS and represent the charge that would have been levied by Scottish Water had the retail non-household market not been opened to competition.

Licensed providers, therefore, compete in the market either by offering a lower price than the default tariff and/or by offering additional or more tailored retail services to their customers.

### *Governance and funding of WICS*

These three activities of WICS are set out in the WICS Corporate Plan for the regulatory period. The current Corporate Plan covers the six years from 2021-22 to 2026-27.<sup>9</sup>

The WICS Corporate Plan also sets out:

- WICS' strategy;
- the funding that WICS will receive through the levies raised from Scottish Water and licensed providers; and
- the key performance indicators (KPIs) that WICS will use to measure its progress on delivering the requirements of the Corporate Plan.

The WICS Board submits the Corporate Plan to the Scottish Government for approval. This means WICS is accountable to Scottish Ministers, through the Scottish Parliament and, ultimately, to water and sewerage customers in Scotland.

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<sup>9</sup> WICS (2020), *'Corporate Plan 2021-27'*, 4 December 2020.

## Appendix 3 – Scottish Ministers’ Commissioning letter

This appendix provides the Commissioning letter for the Strategic Review of Charges 2027-33.

Cabinet Secretary for Wellbeing Economy, Net  
Zero and Energy  
Mairi McAllan MSP  
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**Scottish Government**  
**Riaghaltas na h-Alba**

Donald MacRae  
Chair  
Water Industry Commission for Scotland  
Emailed to: [dmacrae@wics.scot](mailto:dmacrae@wics.scot)

Dear Donald,

### **COMMISSIONING THE STRATEGIC REVIEW OF WATER CHARGES: 2027-2033**

I am writing to commission work to start on the Strategic Review of Charges (“the Review”) for the period 2027-2033. This letter sets out Scottish Ministers’ preferred approach to the Review, building on the successes of previous Reviews, which have ensured a financial and regulatory environment within which Scottish Water has significantly improved levels of efficiency and service delivery. The circumstances within which this Review is taking place are unprecedented – in terms of climate change impacts, nature crisis, ageing assets and economic circumstances. These circumstances should be reflected in the approach that is taken.

Relevant to the Review are the three missions that the First Minister has set out in his [Policy Prospectus](#). I have set them out again here given the key relevance for the water sector vision and Scottish Water in particular:

- Equality: Tackling poverty and protecting people from harm
- Opportunity: A fair, green and growing economy
- Community: Prioritising our public services

Further to consideration of these three missions, the Review needs to respond to:

- The challenges of a changing climate on the industry both in terms of mitigation and adaptation,
- The risks associated with Scottish Water’s ageing asset base,
- The next cycle of River Basin Management Plans for Scotland,
- Our commitment to aligning with new EU legislation in the best interests of Scotland, including the recast Drinking Water Directive and the imminent Urban Wastewater Treatment Directive,
- The ongoing economic situation and cost of living crisis; and
- The need to move to nature-based solutions that deliver on responses to climate change, the nature crisis, environmental protection and green spaces for the enjoyment of Scotland’s population.

In conducting the Review, Ministers look to the Water Industry Commission for Scotland (the Commission) to build on the partnership arrangements with Scottish Water, Consumer Scotland, SEPA, DWQR. In particular, they expect the Commission to enhance and embed its commitment to working with Scottish Water according to the Ethical Business principles<sup>1</sup>. We expect the Commission to work constructively with Scottish Water to collectively ensure the best outcome for Scotland. Those arrangements have developed and evolved over successive reviews to the benefit of customers.

## 1. Conducting the Strategic Review of Charges

Ministers request that the Commission undertakes a Strategic Review of Charges for the six-year period 2027 to 2033. The **Final Determination should be published by 31 October 2026** at the latest to ensure time for Scottish Water to prepare its charging schemes and submit them to the Commission for its approval, and then implement them in time for issuing via Council Tax bills in March 2027. Ministers would welcome sight of a **Draft Determination by June 2026**, but are open to discussion on this timing.

Ministers request that the Draft Determination sets out a range of possible charge paths for both the domestic and non-domestic sectors for the services provided by Scottish Water: drinking water, sewerage and drainage. Ministers want the Review to provide them with the necessary information to appreciate the progress towards objectives and the level of risk of service failure associated with different levels of investment in the short, medium and long terms. In calculating the range of charge paths, for planning purposes the Commission should assume that similar levels of lending to 2021-27 period will be made available (around £1.03 billion).

As the industry is aware, Scottish Ministers recently consulted on policy proposals (Nov-Feb 2024) to equip the Water Industry with the necessary powers to ensure that essential water, wastewater and drainage services can continue to be provide in a changing climate. **The Review must remain cognisant of ongoing policy development and any resulting legislative changes.** Ministers will confirm the extent of changes required in their final Ministerial Objectives.

Ministers request that the Commission ensures, together with water industry stakeholders, that consumers, communities and the environment are placed at the heart of this Review. They expect that the consumers are engaged throughout this process and that the Commission can demonstrate that Final Determination commands consumers' support.

## 2. Principles of Charging

Ministers recognise that their Principles of Charging for previous regulatory periods have provided a framework which has secured significant stability and clarity for

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<sup>1</sup> Ethical Business Regulation and Ethical Business Practice – set out how regulators can deal with asymmetry of information, and evolve from an adversarial relationship to a collaborative one with the regulated entity.

Scottish Water, its customers and stakeholders. The Principles of Charging for the 2027-33 regulatory period will be an evolution of those that currently apply during the 2021-27 regulatory period, and request that the Commission takes these as their starting point with minor amendments (included in Annex B).

Ministers will consult on **Draft Principles of Charging for 2027-33 in early 2025**, and will confirm the final Principles of Charging following the next Scottish Parliament election (likely by September 2026). As in previous periods, the Principles of Charging will indicate the level of finance (lending) they are willing to make available in support of the investment programme.

To ensure continuity, Ministers request that the Commission considers measures that ensure a smooth transition of investment activity between and beyond regulatory periods (current 2021-2027 period to the 2027-33 period being considered in this Review). This is necessary to ensure that supply chains can respond to the investment challenges in the most effective and efficient ways.

### **3. Statement of Ministerial Objectives**

The Ministerial Objectives will be an evolution of those that currently apply during the 2021-27 regulatory period, and Ministers request that the Commission takes these as their starting point with minor amendments (included in Annex C). **Ministers will consult on their draft Ministerial Objectives during 2025**, but due to the Scottish Parliament election will only be able to finalise their objectives by October 2026.

Scottish Ministers will consider their Objectives for the water industry for the regulatory period 2027-33 in light of the emerging challenges facing the industry and emerging policy priorities following the consultation (Nov-Feb 2024). Ministers welcome the Commission's ongoing commitment to, and engagement with, this policy development work.

Ministers will then set their Objectives in the context of the water industry vision describing the longer-term nature of the industry and what it can achieve. The Commission played an important part in the development of that vision and should continue to consider it as the set of outcomes towards which the industry must make clear and demonstrable progress.

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 are attached at Annex A.

Ministers expect that the outputs necessary to achieve their Objectives reflect the best possible value for money in terms of the improvement in outcome achieved for the investment made. Average annual expenditure on the investment programme should remain of a size that allows efficient delivery whilst facing up properly to the challenges the industry and its wider supply chain faces.

With the advice from the Investment Group, Ministers expect a suitable governance structure be developed which identifies, on a rolling basis, the outputs necessary to

deliver their Objectives. Scottish Ministers request that the Commission work with Scottish Water to establish a monitoring framework and process to review the delivery against these Objectives during the Regulatory Period.

Consistent with Ministers' policy of continuity of investment, as set out in the policy prospectus of 2023, and the development of the longer-term vision for the water industry, draft Objectives for the subsequent period 2033-2039 and beyond should also be developed. These must demonstrate how they will contribute to the Government's priorities as set out earlier and make clear and demonstrable progress towards delivering the longer-term vision.

Scottish Water will also be required to continue to meet their statutory obligations in responding to Net Zero and should ensure systematic monitoring and reduction of carbon emissions to ensure that reductions can be quantified. Ministers recognise that adapting services to the impact of climate change is an increasing challenge and wish an explanation to be included in the investment scenarios on the impact of delaying investment on the resilience of services.

#### **4. Next Steps**

In agreeing the timetable for the Review, Ministers ask that Scottish Water and its regulators ensure, in keeping with good practice, that there is appropriate consultation with the wider stakeholder group, communication with customers and for the Government's own public engagement. Ministers request that appropriate steering groups, led by the Scottish Government, are put in place to oversee the stakeholder engagement and to ensure that on-going policy development work is incorporated as required.

Ministers look forward to receiving regular updates on the progress of the 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 Scotland and the Chair of the Competition Commission.

Yours sincerely,



**MAIRI MCALLAN**

## Investment Challenges

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 its assets to ensure no deterioration of service levels to customers over the long term. Ministers accept that capital maintenance is key to achieving and maintaining service levels and compliance with statutory obligations in relation to drinking water quality and the environment and to reflect customer priorities. They wish the Commission to ensure that there is a stable and sustainable funding regime, recognising the economic conditions prevailing and forecast, 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, not least to adapt to the impacts of climate change. They request 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 strategic and local water, sewerage and drainage 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 4 PFI contracts (Seafield, Tay, Moray and Ayrshire) mature in the period 2027-33. Highland and North East have already returned and Daldowie and Dalmuir return in 2026 with Levenmouth the final PFI due to complete in 2040. Scottish Water has been asked to consider the options and costs for the future operation and funding of these assets. Ministers request that the Commission undertake a full examination of Scottish Water's approach to establishing the options and costs with an overall assumption that these assets should return to public ownership.

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 drainage, the reduction of flood risk and compliance with bathing water standards will require Scottish Water to work closely with Local Authorities, Developers, landowners 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 within partnership frameworks.

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 (including hydrogen), and energy efficiency programmes and by working with communities and customers in Scotland for example to manage water demand or create drainage assets. 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.

Security – Ministers recognise the importance of the security of Scottish Water’s physical, operational and IT assets, and the increasing nature of threats particularly in relation to cyber attacks. They require that relevant security standards in relation to physical, personnel and digital systems as advised by Scottish Government Resilient Essential Services and Drinking Water Quality Regulator, should be met.

## Appendix 4 – Meeting the requirements from the Commissioning Letter

This appendix sets out the requirements from the Commissioning letter and how we have addressed them in our methodology.

<b>What does the Commissioning letter require?</b>	<b>How does our methodology address this?</b>	<b>Where in the methodology is it addressed?</b>
The Review needs to respond to the challenges of a changing climate on the industry both in terms of mitigation and adaptation	Our approach recognises these challenges and ensures that Scottish Water will have flexibility to respond. Investment will continue to be defined on a rolling basis through the SGIG governance process, enabling Scottish Water to respond to emerging challenges including those relating to climate change. Furthermore, our regulatory framework will enable Scottish Water to adopt different ways of working to address the challenges posed by a changing climate.	Chapters 4 and 14
The Review needs to respond to the risks associated with Scottish Water’s ageing asset base	Our approach sets an expectation for Scottish Water to develop detailed bottom-up evidence on future asset replacement to complement the top-down analysis conducted for SRC21. As part of this, Scottish Water should provide a measure (or measures) of asset condition across its asset base and, as far as possible, translate the impact of maintenance activities on asset condition into tangible consequences that customers will understand.	Chapters 4, 10 and 14

What does the Commissioning letter require?	How does our methodology address this?	Where in the methodology is it addressed?
<p>The Review needs to respond to the next cycle of River Basin Management Plans for Scotland</p> <p>The Review needs to respond to our commitment to aligning with new EU legislation in the best interests of Scotland, including the recast Drinking Water Directive and the imminent Urban Wastewater Treatment Directive</p>	<p>We expect Scottish Water to set out its proposals for investment and nature based solutions to meet the Objectives of the Scottish Ministers in its business plan. We will then use this information to set an investment baseline in our Final Determination. The baseline will then provide the reference point for investment that progresses through the revised Scottish Government Investment Group (SGIG) governance process to define the investment programme on a rolling basis.</p>	Chapters 6 and 14
<p>The Review needs to respond to the ongoing economic situation and cost of living crisis</p>	<p>Our approach emphasises the importance of Scottish Water evidencing the investment it requires and playing its part in improving efficiency, to reduce the impact on customer charges. This will be important recognising these challenging economic times.</p> <p>Furthermore, our approach of setting a real charge cap over the regulatory period will continue to provide flexibility, allowing Scottish Water to profile charges in response to material changes or specific circumstances such as the cost of living crisis.</p>	Chapters 4, 8, 11, 13 and 14
<p>The Review needs to respond to the need to move to nature-based solutions that deliver on responses to</p>	<p>Our approach encourages Scottish Water to adopt different ways of working to address the challenges</p>	Chapters 13 and 14

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**What does the Commissioning letter require?****How does our methodology address this?****Where in the methodology is it addressed?**

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climate change, the nature crisis, environmental protection and green spaces for the enjoyment of Scotland’s population.

posed by a changing climate. We will encourage Scottish Water to work in partnership with others to find better solutions for customers and the environment. These include nature-based solutions such as catchment management and adopting blue-green infrastructure to deal with excess surface water. Such solutions can deliver broader benefits such as reduced greenhouse gas emissions and enhancing Scotland’s natural and social capital.

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In conducting the Review, Ministers look to...the Commission...to build on the partnership arrangements with Scottish Water, Consumer Scotland, SEPA, DWQR. In particular, they expect the Commission to enhance and embed its commitment to working with Scottish Water according to the Ethical Business principles. We expect the Commission to work constructively with Scottish Water to collectively ensure the best outcome for Scotland.

We have committed to following the principles of Ethical Business Practice and Regulation (EBP&R) for SRC27 and will continue to build upon the collaborative approach adopted for the policy development work with the Scottish Government and Scottish Water.

Chapters 4 and 5

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Ministers request that the Draft Determination sets out a range of possible charge paths for both the domestic and non-domestic sectors for the services provided by Scottish Water: drinking water, sewerage and drainage.

The methodology sets out principles that Scottish Water could apply to allow for a range of charge paths that provide Ministers with the necessary information to understand the progress towards the objectives and the

Chapter 13

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**What does the Commissioning letter require?****How does our methodology address this?****Where in the methodology is it addressed?**

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Ministers want the Review to provide them with the necessary information to appreciate the progress towards objectives and the level of risk of service failure associated with different levels of investment in the short, medium and long terms. In calculating the range of charge paths, for planning purposes the Commission should assume that similar levels of lending to 2021-27 period will be made available (around £1.03 billion).

level of risk of service failures associated with different levels of investment in the short, medium and long term.

As the industry is aware, Scottish Ministers recently consulted on policy proposals (Nov-Feb 2024) to equip the Water Industry with the necessary powers to ensure that essential water, wastewater and drainage services can continue to be provide in a changing climate. The Review must remain cognisant of ongoing policy development and any resulting legislative changes.

Our methodology confirms that we will also ensure that our approach to the Strategic Review of Charges adapts to any changes proposed through the policy development work.

Chapter 4

Our approach also provides flexibility as the Scottish Government’s policy development work concludes and reflects impacts on investment, including in climate adaptation and mitigation, over the 2027-33 regulatory period and beyond.

Ministers request that the Commission ensures, together with water industry stakeholders, that consumers, communities and the environment are placed at the heart of this Review. They expect that the

We will place full ownership on Scottish Water to develop its business plan and demonstrate that customers’ priorities are appropriately reflected. By extension, this will ensure that our Final Determination

Chapter 8

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What does the Commissioning letter require?	How does our methodology address this?	Where in the methodology is it addressed?
<p>consumers are engaged throughout this process and that the Commission can demonstrate that Final Determination commands consumers' support.</p>	<p>of charges commands the support of customers and communities.</p> <p>A tripartite agreement between WICS, Scottish Water and Consumer Scotland sets out key principles underpinning the approach to customer involvement in SRC27.</p>	
<p>To ensure continuity, Ministers request that the Commission considers measures that ensure a smooth transition of investment activity between and beyond regulatory periods (current 2021-2027 period to the 2027-33 period being considered in this Review).</p>	<p>The investment programme will continue to be defined on a rolling basis through the SGIG, ensuring a smooth transition of investment activity between regulatory periods.</p>	Chapter 14
<p>Ministers expect that the outputs necessary to achieve their objectives reflect the best possible value for money in terms of the improvement in outcomes achieved for the investment made.</p>	<p>Our approach will ensure that this is the case, through:</p> <ul style="list-style-type: none"> <li>the requirement for a clear linkage between inputs, outputs and outcomes as part of the investment baseline; and</li> <li>our approach to efficiency, which involves a combination of different methods.</li> </ul>	Chapters 13 and 14
<p>Average annual expenditure on the investment programme should remain of a size that allows efficient</p>	<p>We will complete work to understand a top-down view of the size of investment programme that Scottish Water could deliver efficiently, recognising the capacity</p>	Chapter 14

What does the Commissioning letter require?	How does our methodology address this?	Where in the methodology is it addressed?
<p>delivery whilst facing up properly to the challenges the industry and its wider supply chain faces.</p>	<p>of the supply chain and Scottish Water’s own capacity to deliver the investment programme. We will work with Scottish Water to develop a scope of work in line with the principles of EBP&amp;R.</p>	
<p>Scottish Ministers request that the Commission work with Scottish Water to establish a monitoring framework and process to review the delivery against these objectives during the Regulatory Period.</p>	<p>Our approach is based on investment being identified on a rolling basis through the SGIG. We will work together with the stakeholders in the SGIG to revise the governance process in line with the expectations from the Commissioning letter.</p>	Chapter 14
<p>Scottish Water will also be required to continue to meet their statutory obligations in responding to Net Zero and should ensure systematic monitoring and reduction of carbon emissions to ensure that reductions can be quantified. Ministers recognise that adapting services to the impact of climate change is an increasing challenge and wish an explanation to be included in the investment scenarios on the impact of delaying investment on the resilience of services.</p>	<p>Our business plan guidance and data tables provide outcome measures. These will include measures to allow Scottish Water to demonstrate its progress towards reducing operational emissions.</p> <p>The methodology sets out principles that Scottish Water could apply to allow for a range of charge paths that provide Ministers with the necessary information to understand the progress towards the objectives and the level of risk of service failures associated with different levels of investment in the short, medium and long term. This includes providing an explanation on the</p>	Chapters 14 and 15

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**What does the Commissioning letter require?****How does our methodology address this?****Where in the methodology is it addressed?**

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impact of delaying investment on the resilience of services.

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 its assets to ensure no deterioration of service levels to customers over the long term. Ministers accept that capital maintenance is key to achieving and maintaining service levels and compliance with statutory obligations in relation to drinking water quality and the environment and to reflect customer priorities. They wish the Commission to ensure that there is a stable and sustainable funding regime, recognising the economic conditions prevailing and forecast, for this important part of the investment programme.

Our approach sets an expectation for Scottish Water to develop detailed bottom-up evidence on future asset replacement to complement the top-down analysis conducted for SRC21. As part of this, Scottish Water should provide a measure (or measures) of asset condition across its asset base and, as far as possible, translate the impact of maintenance activities on asset condition into tangible consequences that customers will understand.

Chapters 4, 10 and 14

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, not least to adapt to the impacts of climate change. They request that the Commission provides assurance that Scottish Water’s approach is

We expect Scottish Water to set out its proposals for investment and nature based solutions to meet the Objectives of the Scottish Ministers in its business plan. We will then use this information to set an investment baseline in our Final Determination. The baseline will then provide the reference point for investment that

Chapter 14

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**What does the Commissioning letter require?****How does our methodology address this?****Where in the methodology is it addressed?**

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 strategic and local water, sewerage and drainage 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

progresses through the revised Scottish Government Investment Group (SGIG) governance process to define the investment programme on a rolling basis.

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Private Finance Initiative funded Projects - Ministers recognise that 4 PFI contracts (Seafield, Tay, Moray and Ayrshire) mature in the period 2027-33. Highland and North East have already returned and Daldowie and Dalmuir return in 2026 with Levenmouth the final PFI due to complete in 2040. Scottish Water has been asked to consider the options and costs for the future operation and funding of these assets. Ministers request that the Commission undertake a full examination of Scottish Water’s approach to establishing the options

We also consider that it is appropriate to place additional information requirements on specific categories of projects, including Private Finance Initiative funded projects, recognising that Ministers have requested WICS undertake a full examination of Scottish Water’s approach to establishing the options and costs of the 4 PFI contracts maturing in the 2027-33 regulatory period.

Chapter 14

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**What does the Commissioning letter require?****How does our methodology address this?****Where in the methodology is it addressed?**

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and costs with an overall assumption that these assets should return to public ownership.

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 drainage, the reduction of flood risk and compliance with bathing water standards will require Scottish Water to work closely with Local Authorities, Developers, landowners 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 within partnership frameworks

For changes to operating expenditure resulting from the adoption of operational solutions instead of capital investment solutions, or from partnership arrangements with local authorities or other third parties, we expect Scottish Water to provide more detailed information to enable us to ensure that the funding arrangements are sufficiently flexible.

Chapters 13 and 14

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 (including

Our approach provides Scottish Water with flexibility in its investment planning, reducing the regulatory barriers to collaboration and innovation.

Chapters 4, 13 and 14

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What does the Commissioning letter require?	How does our methodology address this?	Where in the methodology is it addressed?
<p>hydrogen), and energy efficiency programmes and by working with communities and customers in Scotland for example to manage water demand or create drainage assets. 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.</p>	<p>We expect Scottish Water to set out its proposals for investment and nature based solutions to meet the Objectives of the Scottish Ministers in its business plan. We will then use this information to set an investment baseline in our Final Determination. The baseline will then provide the reference point for investment that progresses through the revised Scottish Government Investment Group (SGIG) governance process to define the investment programme on a rolling basis.</p>	<p>Chapters 4, 13 and 14</p>

## Appendix 5 – Core and non-core categorisation in SRC06

This appendix provides further information on the categorisation of core and non-core activities for the Strategic Review of Charges 2006-10 (SRC06).

*Table 1: Core and non-core categorisation in SRC06*

<b>Classification</b>	<b>Activities</b>
<b>Core</b>	<ul style="list-style-type: none"><li>• Abstraction, treatment, storage, conveyance &amp; distribution of potable water</li><li>• Conveyance, treatment &amp; disposal of sewage including public septic tanks</li><li>• Quality control</li><li>• Call centre for interruptions, quality problems, flooding</li><li>• Customer information systems</li><li>• GMS appropriate to interruptions, flooding, and infrastructure etc.</li><li>• Supply pipe repair</li><li>• Supply installation</li><li>• Physical disconnection</li><li>• Communication/education of flush/don't flush, reservoir safety</li><li>• Retail contract management &amp; systems</li><li>• Customer information systems</li><li>• Customer account management (key account management)</li><li>• Customer meter reading</li><li>• Customer billing</li><li>• Customer revenue collection</li><li>• Customer debt collection</li><li>• Customer debt write-off</li><li>• GMS appropriate to billing, complaints etc.</li><li>• Metering</li><li>• Disconnection notification</li></ul>
<b>Non-core</b>	<ul style="list-style-type: none"><li>• Added value services – insurance, bottled water etc.</li><li>• Non-domestic septic tank emptying</li><li>• Communication/education</li><li>• Tailored service consultancy</li><li>• Grey water</li><li>• General engineering consultancy</li><li>• Film location services</li><li>• Forestry</li></ul>

## Appendix 6 – Expenditure and Financial ratio definitions

This appendix sets out the definitions of the different categories of expenditure and the definition of the financial ratios that we will use for the Strategic Review of Charges 2027-33 (SRC27).

*Table 2: Expenditure definitions*

<b>Category</b>	<b>Definition</b>
<b>Operating expenditure</b>	Spending on ongoing, day-to-day activities required to provide water and wastewater services.
<b>PFI expenditure</b>	Regular payments to third-party organisations providing wastewater assets and services on behalf of Scottish Water for a period under legacy contracts.
<b>Interest</b>	The finance costs on Scottish Water’s existing loans and additional borrowing that Scottish Water receives each year from the Scottish Government (less the interest on the loans repaid in the year). It is also net of any interest that Scottish Water receives on any cash balances that it holds.
<b>Taxation</b>	Corporation tax payable to HMRC on profits made during the financial year.
<b>Repairs</b>	Investment in fixing an asset to ensure that it can continue to operate.
<b>Refurbishment</b>	Investment in a renovation or overhaul of older or damaged equipment or replacement of parts within a piece of equipment to bring the asset back to a workable condition to extend the expected life of the asset.
<b>Asset replacement</b>	Investment in the replacement of an asset whether that be equipment, or whole process/site or section of infrastructure.
<b>Enhancement</b>	Investment that results in incremental improvements in levels of service provided or levels of compliance.
<b>Growth</b>	Investment to meet new demand.
<b>Capital investment</b>	Covers repair, refurbishment, asset replacement, enhancement and growth investment as defined above.
<b>Capital maintenance investment</b>	Covers repair, refurbishment and asset replacement investment as defined above.

Table 3: Ratio definitions

<b>Ratio</b>	<b>Definition/rationale</b>
<b>Cash interest cover</b>	A measurement of the ability of a company to meet its interest expenditure after deducting operating costs (pre interest) from revenues.
<b>Cash interest cover (net of maintenance)</b>	A measurement of the ability of a company to meet its interest expenditure after deducting operating costs (pre interest) and maintenance (repair, refurbishment and replacement) costs from revenues.
<b>Cash interest cover (net of expensed investment)</b>	A measurement of the ability of a company to meet its interest expenditure after deducting operating costs (pre interest) and expensed investment from revenues.
<b>Gearing</b>	A measure of the capacity of a company to raise additional debt against its assets, using the ratio of the company's net debt to regulatory capital value (RCV).
<b>FFO: Net debt</b>	A measurement of a company's debt compared to its operating cash flows (post interest).
<b>FFO: Net debt (net of expensed investment)</b>	A measurement of a company's debt compared to its operating cash flows (post interest) less expensed investment.

## Appendix 7 – Regulatory practice on setting an efficiency challenge on operating expenditure

This appendix sets out the regulatory precedent on the approaches economic regulators use to identify the scope for operating expenditure efficiency.

### Ofwat PR19 and CMA updates

Ofwat’s price review 2019 (PR19) approach involves benchmarking operational and capital maintenance expenditure as well as some specific enhancement costs together as BotEx (base expenditure).<sup>10</sup> There are 5 econometric models for water and 8 for wastewater, covering activities of water resources, water network plus, wastewater network plus and bioresources, details of which are listed in Table 4.<sup>11, 12</sup> They use data from Annual Performance Reports and business plans submitted by companies and other external sources.

*Table 4: Econometric models used in PR19 updated by the UK CMA*

<b>Econometric model</b>	<b>Explanatory variables</b>
<b>Water resources plus 1</b>	Number of properties, % of water treated complexity levels bands 3-6, weighted average density
<b>Water resources plus 2</b>	Number of properties, weighted average water treatment complexity, weighted average density
<b>Treated water distribution</b>	Weighted average density, lengths of main, number of booster pumping stations
<b>Wholesale water 1</b>	Number of properties, % of water treated complexity levels bands 3-6, weighted average density, number of booster pumping stations, lengths of main
<b>Wholesale water 2</b>	Number of properties, weighted average water treatment complexity, weighted average density, number of booster pumping stations, lengths of main
<b>Sewage collection 1</b>	Sewer length, pumping capacity, number of properties
<b>Sewage collection 2</b>	Sewer length, pumping capacity, weighted average density
<b>Sewage Treatment 1</b>	Load, % load treated in bands 1-3, % load with ammonia <3mg/l
<b>Sewage Treatment 2</b>	Load, % load with ammonia <3mg/l, % of load treated in band 6

<sup>10</sup> Ofwat (2020), ‘Final determinations models’, 14 October 2020.

<sup>11</sup> Ofwat (2021), ‘Competition and Markets Authority referrals – Cost models: Regression water – CMA FD’, 20 July 2021.

<sup>12</sup> Ofwat (2021), ‘Competition and Markets Authority referrals – Cost models: Regression wastewater – CMA FD’, 20 July 2021.

<b>Bioresources 1</b>	Weighted average density, % load treated in bands 1-3, sludge produced
<b>Bioresources 2</b>	Sludge produced, number of sewage treatment works
<b>Bioresources plus 1</b>	Load, % load treated in bands 1-3, % load with ammonia <3mg/l
<b>Bioresources plus 2</b>	Load, % load with ammonia <3mg/l, % of load treated in band 6

The econometric models generate coefficients for calculating modelled costs. The predicted expenditure from the different models is then combined (what Ofwat calls ‘triangulated’) based on a weighted average of the results from each of the models.

Ofwat adjusts for cost adjustment claims after the econometric benchmarking, allowing companies to reflect specific circumstances that have a material impact on costs. Finally, the triangulated wholesale costs are compared to the actual costs to determine the catch-up efficiency challenges.<sup>13</sup>

The PR19 models use cost data over an 8-year period from 2011/12 to 2018/19 for the econometric sample (i.e. calculating the model coefficients), and cost data over a 5-year period from 2014/15 to 2018/19 for the catch-up efficiency challenge calculation. The Competition and Markets Authority used the econometric models with some adjustments in the case of the PR19 appeals from Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water. The CMA used the same periods together with the more recent data from 2019/20. The CMA also set a different catch-up benchmark, as shown in Table 5.<sup>14</sup>

### **Ofwat PR24**

Ofwat has further developed its econometric models to assess base expenditure for its price review 2024 (PR24). These models are covered in further detail in Ofwat’s draft determinations for PR24.<sup>15</sup>

<sup>13</sup> Ofwat (2019), ‘PR19 final determinations: Securing cost efficiency technical appendix’, 16 December 2019.

<sup>14</sup> Competition and Markets Authority (2021), ‘Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Final report’, 17 March 2021.

<sup>15</sup> Ofwat (2024), ‘PR24 draft determinations – Expenditure allowances’, 11 July 2024.

Table 5: Efficiency challenges set in different price reviews

Price Review	Sector	Years	Real Price Effects	Frontier	Catch-up Benchmark
Ofwat PR19	Water	2020-2025	0.47% <sup>16</sup>	1.1%	To catch up with the 4th company out of 17 water companies and the 3rd company out of 10 wastewater companies
CMA appeals PR19	Water	2020-2025	0.47% <sup>17</sup>	1%	Efficiency challenges to catch up with the upper quartile
Ofwat PR24	Water	2025-2030	adjustment for labour and energy costs with ex post true-ups	1%	Efficiency challenges to catch up with the upper quartile
Ofgem RIIO-ED2	Electricity Distribution	2023-2028	indexation approach with ex post adjustments based on materiality <sup>18</sup>	1% <sup>19</sup>	3-year glide path from the 75 <sup>th</sup> percentile in 2023 to the 85 <sup>th</sup> percentile in 2026
Ofgem RIIO-GD2	Gas Distribution	2021-2026	as above	1.2% <sup>20</sup>	3-year glide path from the 75 <sup>th</sup> percentile in 2021 to the 85 <sup>th</sup> percentile in 2024
Ofgem RIIO-T2	Gas and Electricity Transmission	2021-2026	as above	1.2%	Not applicable
WICS SRC21	Water	2021-2027	-	1%	Not applicable

<sup>16</sup> Calculated 5-year average from Ofwat FD models.

<sup>17</sup> Calculated 5-year average from CMA FD models.

<sup>18</sup> Ofgem (2020), 'RIIO-ED2 Sector Methodology Decision: Annex 2 Keeping bills low for consumers', 17 December 2020.

<sup>19</sup> Ofgem (2022), 'RIIO-ED2 Final Determinations Overview document', 30 November 2022.

<sup>20</sup> Ofgem (2020), 'RIIO-2 Final Determinations - Core Document', 8 December 2020.

## Appendix 8 – Regulatory practice on setting investment requirements

This appendix sets out the regulatory precedent on how economic regulators set efficient investment allowances.

### OFWAT

Ofwat aggregates expenditure differently to WICS, distinguishing between base and enhancement expenditure. It defines base expenditure as the routine, year-on-year expenditure that companies incur in the normal running of their business to provide a base level of good service to customers and the environment.<sup>21</sup> It includes what we refer to as operating expenditure and asset maintenance expenditure. Ofwat also explains that it covers expenditure to comply with current legal obligations and expenditure to improve efficiency.

Ofwat uses statistical models to set the efficient level of base expenditure, which, as set out above, includes asset maintenance expenditure. These models seek to control for factors that drive differences in costs across companies, which are largely beyond the control of the company such as the company's size, population density and treatment complexity.

Ofwat defines enhancement expenditure as arising where there is a permanent increase or step change in the current level of service to a new 'base' level and/or the provision of services to meet new demand from customers. As such, Ofwat's definition of enhancement includes what we refer to as enhancement and growth investment.

Focusing on enhancement investment, like WICS, Ofwat recognises the importance of planning investment over the long-term. It introduced long-term delivery strategies, which companies prepare and present alongside their business plan submissions. Ofwat's expectation is that the new statutory requirements placed on companies under the water industry national environment programme (WINEP) in England and the National environment Programme (NEP) in Wales will inform these long-term delivery strategies. These long-term delivery strategies are based on an adaptive planning framework.<sup>22</sup>

Adaptive planning involves considering different scenarios covering a range of external factors that impact on investment requirements such as the extent of climate change and/or population growth. It is an emerging approach to investment planning which recognises the uncertainties of future challenges and is designed to be flexible. It is promoted by HM Treasury in its Green Book guidance for accounting for the effects of climate change and has been implemented by Ofwat in its PR24

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<sup>21</sup> Ofwat (2022), *'Creating tomorrow, together: Our final methodology for PR24'*, 13 December 2022, p.76.

<sup>22</sup> Ofwat (2022), *'PR24 and beyond: Final guidance on long-term delivery strategies'*, 6 April 2022.

methodology.<sup>23</sup> The aim of the approach is to identify the most efficient pathways possible to meet long-term outcomes, given future uncertainties, and identify the enhancement investment that is either no or low regrets, reducing the risk of inefficient investment. It therefore allows companies to identify the enhancement investment required over the regulatory period.

Ofwat requires companies to prepare comprehensive business cases for enhancement investment across all enhancement areas.<sup>24</sup> The business cases should provide sufficient and convincing evidence, covering:

- the need for enhancement investment;
- best options for customers;
- cost efficiency; and
- customer protection.

The remainder of this section focuses on the latter two areas: cost-efficiency and customer protection.

On cost efficiency, where there is investment that is comparable across companies, Ofwat uses statistical and unit cost models to determine efficient cost allowances. Ofwat also uses information from industry data bases and expert cost consultants to inform these comparative assessments.<sup>25</sup> For example, some companies, like Anglian Water,<sup>26</sup> have followed this benchmarking approach of comparing unit costs against its own database, the available unit costs of other companies as well as external consultants' cost libraries as part of their enhancement investment business cases.

Among the 40 enhancement models used in Ofwat's price review in 2019 (PR19), there are 13 sub-models in linear, logarithm or quadratic scales or unit cost method that model the total expenditure allowances in respective categories. There are also 6 median unit cost models which use the median as the benchmark level, as shown in Table 8.<sup>27</sup> Where the use of such models is unsuitable or not feasible, Ofwat undertakes more bespoke and in-depth analysis that is proportionate to the materiality of expenditure. The regulator refers to these as 'deep-dives', where proposed expenditure is material, and 'shallow-dives' in other cases.

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<sup>23</sup> HM Treasury (2013), '*Green Book supplementary guidance: climate change and environmental valuation*', 21 April 2013.

<sup>24</sup> Ofwat (2022), '*Creating tomorrow, together: Our final methodology for PR24, Appendix 9 – Setting expenditure allowances*', 7 July 2022, p.23.

<sup>25</sup> Ofwat (2022), '*Creating tomorrow, together: Our final methodology for PR24. Appendix 9 – Setting expenditure allowances*', 7 July 2022, p.20.

<sup>26</sup> Anglian Water (2023), '*Our PR24 Enhancement Strategies. Part 1: Resilient to the risk of drought and flood*', 2 October 2023.

<sup>27</sup> Ofwat (2020), '*Final determinations models*', 14 October 2020.

Some models listed in Table 6 may not be applicable for Scottish Water.<sup>28</sup> However, others could be adapted and used in Scotland to benchmark Scottish Water’s costs against the costs of the companies in England and Wales.

*Table 6: Regression and unit cost sub-models used in PR19 for enhancements*

<b>Model name</b>	<b>Model type</b>	<b>Cost driver</b>
Lead standards: Step1	Log <sup>29</sup>	Number of lead communication pipes replaced for water quality purposes
Lead standards: Step2	Unit cost	Pipes replaced for water quality purpose
Metering 1	Linear	Combined number of optant and selective meters installed
Metering 2	Log	Combined number of optant and selective meters installed
Supply demand balance 1	Median unit cost	2020-25 SDB enhancement cost
Supply demand balance 2	Median unit cost	Leakage enhancement cost
Chemicals removal	Log	1. the population equivalent served by wastewater treatment works with a WFD_CHEM_IMP driver code (As necessary, we source the p.e. data from the European Commission WISE database <sup>30</sup> ); 2. the average proposed permit level for zinc
Event duration monitoring 1	Median unit cost	Installations
Event duration monitoring 2	Median unit cost	Permits
First time sewerage	Quadratic	Number of connectable properties served by s101A schemes
Flow monitoring 1	Median unit cost	New monitor installations & upgrades
Flow monitoring 2	Median unit cost	Investigations
Flow to full treatment (FFT) 1 <sup>31</sup>	Linear	Number of schemes and cumulative FFT shortfall

<sup>28</sup> First time sewage is an obligation for wastewater companies under the Water Industry Act 1991 (s101A) which applies to England and Wales.

<sup>29</sup> Models in logarithm scale include log-linear and log-log models.

<sup>30</sup> The WISE Water Framework Directive database contains data for Scotland with River Basin District Code of UK01.

<sup>31</sup> Flow to full treatment (FFT) is a measure of how much wastewater a treatment works must be able to treat at any time. See further explanation at <https://www.ofwat.gov.uk/flow-to-full-treatment-fft-explainer/>. It is required in the water industry strategic environmental requirements (WISER) which is a guidance applies to England. This scheme is not required in Scotland, although Scottish Water does have projects for this purpose.

Flow to full treatment (FFT) 2	Standardised log	Number of schemes and cumulative FFT shortfall
Nutrients (Phosphorus removal) 1	Linear	Number of wastewater treatment works subject to a new or tightened consent and the population equivalent (p.e.) served by these works
Nutrients (Phosphorus removal) 2	Linear	p.e. and number of enhanced wastewater treatment works with a proposed consent at or below 0.5 mg/l
Spill frequency 1	Linear	Volume of storage each company is planning to construct
Spill frequency 2 <sup>32</sup>	Log	Volume of storage each company is planning to construct, number of sites
Storm tank capacity 1	Log	Total storage volume
Storm tank capacity 2	Log	Total storage volume and the number of schemes

Ofwat has developed further enhancement models for its draft determinations for its price review 2024 (PR24), including through benchmarking individual investment schemes. These models are covered in further detail in Ofwat’s draft determinations for PR24.<sup>33</sup>

On customer protection, Ofwat has introduced price control deliverables (similar to what we would call outputs) to enable them to hold companies to account for timely delivery of the outcomes and outputs that they promise.<sup>34</sup> In their guidance on price control deliverables, Ofwat provides examples of deliverables for different categories of investment, covering:

- for investment to increase water supplies, a deliverable could take the form of additional water available for use in MI/d; and
- for investment to reduce storm overflows, a deliverable could take the form of additional storage provided (in m<sup>3</sup>), number of sites or number of modelled spills reduced.<sup>35</sup>

Ofwat will use the price control deliverables to track delivery and return funding to customers where companies do not deliver the outputs that they have been funded to.<sup>36</sup>

## THE CIVIL AVIATION AUTHORITY (CAA)

The Civil Aviation Authority (CAA) is responsible for the regulation of aviation safety in the United Kingdom. As part of its responsibilities, the CAA has powers to apply economic regulation to airport

<sup>32</sup> This log model with two cost drivers applies to Anglian Water only as requested by company after PR19 Draft Determination.

<sup>33</sup> Ofwat (2024), ‘PR24 draft determinations – Expenditure allowances’, 11 July 2024.

<sup>34</sup> Ofwat (2022), ‘Creating tomorrow, together: Our final methodology for PR24’, 13 December 2022, p.18.

<sup>35</sup> Ofwat (2023), ‘Information notice: IN23/05 further guidance on price control deliverables for PR24’, 4 July 2023.

<sup>36</sup> Ofwat (2022), ‘Creating tomorrow, together: Our final methodology for PR24’, 13 December 2022, p.61.

operators that it deems have substantial market power.<sup>37</sup> Under these arrangements, the CAA applies economic regulation to Heathrow Airport, which involves the CAA setting:

- a price cap on the charges that Heathrow Airport collects from airlines; and
- the quality of services provided for those charges.

For the H7 price control, the CAA set the efficient level of investment based on Heathrow Airport's investment plan. The CAA assessed the proposed investment baseline from the plan in two stages:

- a structured needs assessment, involving allocating projects into categories according to the level of information provided and the overall business case for the project; and
- an assessment of what the efficient costs of the required investment which built on earlier advice from its technical advisors, Arcadis.

The latter assessment of efficient cost covered:

- engagement with Heathrow on the basis of the material contained in its H7 investment plan and the supporting information provided;
- conducting a review of how the costs were developed, including reviewing the integrity and calculations of costing for elements of projects/programmes and reviewing the scope of relevant projects; and
- benchmarking selected unit rates for standardised works, including reviewing the assumptions underpinning the proposed costs.

Based on its assessment, the CAA set an efficient allowance for investment of £3.6 billion (2020 prices), which was around £1 billion (20%) lower than what Heathrow Airport proposed in its investment plan.<sup>38</sup> The CAA segmented the investment plan into a 'core' and 'development' elements. The core element related to projects where the requirement, scope and budget had been agreed jointly with Heathrow and the airlines. The development element involved a separate governance process involving the airlines approving the investment.<sup>39</sup> Heathrow Airport appealed certain aspects of the CAA's proposed approach (specifically the capex incentives and the requirements for outputs for all projects) to the UK Competition and Markets Authority (CMA).<sup>40</sup>

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<sup>37</sup> Civil Aviation Authority, 'H7 overview: We are developing the regulatory framework for Heathrow Airport Limited', webpage.

<sup>38</sup> Civil Aviation Authority (2022), 'Economic regulation of Heathrow Airport: H7 Final Proposals Section 2: Building blocks', June, pp.75-76.

<sup>39</sup> Heathrow Airport adopts a 'Gateway' process, through which prospective capital investment projects progress from Gateway 0, where the need for investment is identified, to Gateway 8, where retrospective review of the delivered investment takes place. Gateway 3 is when a project transitions from 'development' to the 'core' programme. The Competition and Markets Authority (CMA) provided background on the Gateway process in the context of Heathrow Airport's appeal of the CAA's price control and the consequential licence modifications. See CMA (2023), 'H7 Heathrow Airport Licence Modification Appeals: Final Determinations', 17 October 2023, p.440.

<sup>40</sup> In aviation, the appeal process differs from that in the water industry. In aviation, the appellant refers specific issues to the CMA on the grounds that the regulator's decision was wrong in law. The regime is known as appeals on merits. In the water industry, the appellant refers the full determination to the CMA, who then redetermines the charge caps.

The CMA found in favour of the CAA,<sup>41</sup> leading to the CAA confirming its approach in November as part of its guidance on the governance of investment.

The guidance sets out several requirements. We focus on three of these requirements, which we consider could have lessons for the water industry in Scotland, covering:

- standard information provision
- in-depth review of specific projects
- delivery obligations

#### *Standard information provision*

The CAA's guidance sets out a standardised set of questions or information that should be applied to all projects. This information is to help support the engagement between Heathrow and the airlines, where both parties must agree to the investment projects for a project to move from the development element of the investment programme to the core element of the investment programme. For each project, Heathrow has to provide information on:

- Project need;
- Project outputs and delivery timetable;
- Operational impact;
- What will constitute completion of the project;
- Options considered;
- Risks/ opportunities;
- Costs;
- Quantifiable benefits and significant non-quantifiable benefits; and
- Standards and processes applied (e.g. asset management strategy and policy).

As part of the process, airlines can review and challenge common standards and processes that Heathrow applies across its investment programme. These include areas such as the approach to asset management, design and planning standards and the approach to risk management, all of which have an impact on project costs. Recognising that some of these standards and processes require specialist knowledge, the airlines can seek an independent view with reference to wider best practice. The selection of the reviewer is to be agreed between both parties, with the report provided to both parties at the same time.

#### *In-depth review of specific projects*

In addition to the standard information, projects that are more complex, costly or have a greater impact on airlines can be subject to a more detailed review to provide assurance to the airlines that Heathrow Airport has considered several key factors. These factors include:

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<sup>41</sup> Competition and Markets Authority (2023), 'H7 Heathrow Airport Licence Modification Appeals: Final Determinations', 17 October 2023, p.492.

- underlying drivers for the project;
- different solution options that have been considered, including the assessment of relative costs, risks, benefits and operational impacts of each option (a business case assessment);
- opportunities where Heathrow Airport has sought to seek further efficiencies by coordinating works with other schemes;
- the procurement process that Heathrow Airport has undertaken to secure value-for-money;
- benchmark cost information that Heathrow Airport has used to assure the efficiency of the proposed project; and
- the approach to identifying and managing risks.

The expectation is that such a review would require input from independent consultants with expertise in project or programme development and construction, to compare Heathrow Airport's approach against industry good practice. Heathrow is expected to produce a list of projects that are due to be proceed through the approval gate (Gate 3) in its investment process six months in advance of the year that the projects are due to reach the approval gate. This list forms the basis of projects that Heathrow and the airlines agree should be subject to more detailed review. There is no minimum cost threshold for projects that should be subject to review, recognising that some projects of a lower value may be more complex or have a critical impact on an airline's operations and, therefore, merit further review.

### *Delivery obligations*

One of the areas that the Heathrow Airport disputed in relation to the CAA's Final Determination was the requirement for each project to have delivery obligations for all projects. In its appeal to the CMA, one of Heathrow Airport's arguments was that the requirement for delivery obligations for all projects was not targeted or proportionate and that the CAA was wrong in law or made an error.<sup>42</sup> As set out above, the CMA found in favour of the CAA.

Recognising the finding from the appeal to the CMA, the CAA requires all projects proceeding through the approval gate (Gate 3) to have delivery obligations. The delivery obligations are based on SMART objectives<sup>43</sup> and cover outputs and delivery timescales. These delivery obligations are to provide an objective means for establishing whether a project has been delivered in line with the assumptions that informed the original budget and delivery programme. They can cover individual projects and tranches of projects. The delivery obligations can also be based on outcomes, provided the outcomes can be defined using SMART metrics.

Heathrow Airport is also required to set out annually its performance against the delivery obligations, providing information on a project basis covering:

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<sup>42</sup> Competition and Markets Authority (2023), 'H7 Heathrow Airport Licence Modification Appeals: Final Determinations', 17 October 2023, p.441.

<sup>43</sup> Specific, measurable, achievable, relevant and time-bound.

- the baseline expenditure agreed at the approval gate;
- the delivery obligations agreed at the approval gate;
- performance against the delivery obligations once the project is complete; and
- the actual expenditure incurred.

### **OFFICE OF RAIL AND ROAD (ORR)**

The Office of Rail and Road (ORR) is the economic regulator of Network Rail. The ORR conducts a process called a periodic review, which is equivalent to our Strategic Review of Charges (SRC), to determine what Network Rail is expected to deliver in relation to its operating, support, maintenance and renewal of the rail network and the funding that it requires to support these activities. The most recent periodic review was completed in 2023 (PR23) and covers the period from 1 April 2023 to 31 March 2029 (which ORR calls control period 7, CP7).

Through its periodic review process, the ORR only assesses funding required to deliver the efficient level of maintenance and renewals investment. Enhancement investment is developed, and the funding settlement agreed, outside of the periodic review under a ‘pipeline approach’ (led by the Department for Transport, rather than the ORR). The ORR continues to play a role in monitoring the delivery of the enhancements programme, but no longer establishes efficient costs in advance.

Network Rail’s business plan sets out its proposals for maintenance and renewals, which the ORR then examines in coming to its Draft Determination. In examining the investment programme, the ORR conducts both top-down analysis and bottom-up analysis.<sup>44</sup> An example of the top-down analysis relates to the ORR’s approach to digital signalling schemes, where the ORR conducted statistical analysis of trends in Network Rail’s unit rates for infrastructure renewals and concluded that the unit rates were not sufficiently mature and were too high.<sup>45</sup> An example of the bottom-up analysis relates to the ORR’s targeted assurance reviews of Network Rail’s specific activities, with one such review covering Network Rail’s approach to maintenance planning and delivery and the scope for improvements in this area.<sup>46</sup>

As well as conducting its own targeted assurance reviews, the ORR relies on independent experts as set out in chapter 7 on assurance. In 2022, for example, the ORR conducted a review of Network Rail’s contract management arrangements, to inform the ORR’s PR23 and ongoing monitoring of Network Rail’s performance.<sup>47</sup>

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<sup>44</sup> Office of Rail and Road (2023), ‘PR23 draft determination: supporting document – sustainable and efficient costs’, 15 June 2023, pp.17-18.

<sup>45</sup> Office of Rail and Road (2023), ‘PR23 draft determination: supporting document – sustainable and efficient costs’, 15 June 2023, p.30 and Annex G.

<sup>46</sup> Office of Rail and Road (2022), ‘Network Rail’s approach to maintenance: targeted assurance review’, August.

<sup>47</sup> GHD and Gleeds (2022), ‘Independent Report #28127 Part A – Review of Network Rail’s contract management’, report prepared for the Office of Rail and Road and Network Rail, July 2022.

These previous two examples demonstrate that the ORR also examines areas that relate to the overall investment programme.

Following the Final Determination, Network Rail produces a delivery plan, which sets out how it will deliver the Final Determination set by the ORR. One of the purposes of the delivery plan is to provide a transparent baseline against which Network Rail will report its progress and which the ORR will use monitor delivery and hold Network Rail to account.<sup>48</sup> The delivery plan contains Network Rail's forecast of expenditure and the key outcomes, outputs and targets that Network Rail will meet.<sup>49</sup> Each year, Network Rail will update its delivery plan with any changes made transparently.

The delivery plan is one important mechanism that the ORR has available to deal with changes to the regulatory settlement during the regulatory period.

### **OFFICE OF GAS AND ELECTRICITY MARKETS (OFGEM)**

As part of their RIIO-3 methodology<sup>50</sup>, Ofgem have set out the four key outcomes for the industry for the next regulatory period:

- infrastructure fit for a low-cost transition to net zero;
- secure and resilient supplies – the network should also be efficient, data rich and adaptable;
- high quality of service from regulated firms; and
- system efficiency and long-term value for money.

Network companies use a common reference scenario to develop the investment plan that will deliver these outcomes. Ofgem proposes that all companies use the Energy System Operator's Future Energy Scenario (FES) 2023 "Leading the way" for their draft business plans which represents the fastest credible decarbonisation pathway and assumes customer behaviour and lifestyle will change considerably with electrification and some hydrogen decarbonising heating. In their final business plans using FES 2024 which will be published after the draft business plans.

Ofgem is proposing to continue with their RIIO-2 approach (with some modifications) of using price control deliverables (PCDs) to drive the delivery of the above outcomes and ensure customers receive the outputs they have paid for. The regulator proposes to set two types of PCDs: evaluative and mechanistic. The former is used when the actual work delivered can vary from what the company has submitted in its business plan in terms of cost, timings and outputs. Mechanistic PCDs are used for typically repeatable activities which can be defined by volume or number of units delivered, and allowances can be set based on unit costs. For each PCD, Ofgem specifies the outputs to be delivered, the date they should be delivered by, and the allowed for expenditure. Some of the proposed approach modifications for RIIO-3 include:

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<sup>48</sup> Office of Rail and Road (2023), 'CP7 Delivery Plan notice', October 2023.

<sup>49</sup> See Network Rail (2024), 'Our delivery plan for control period 7: 1 April 2024 to 31 March 2029', p.22. See also Network Rail (2024), 'CP7 Delivery Plan: Consolidated CP7 Outcomes forecast and targets: 2024-2029'.

<sup>50</sup> Ofgem (2023), 'RIIO-3 Sector Specific Methodology Consultation – Overview Document', 13 December 2023.

- asking companies to identify the consequences of any delay or failure to deliver PCDs including impact on customers and transition to net zero; and
- making PCDs more flexible by setting their outputs with a greater focus on outcomes.

Other incentives which Ofgem uses are “truth telling incentives” (i.e. high-quality, comprehensive and ambitious business plan data submissions) and efficiency incentives. In relation to truth telling incentives Ofgem proposes to build upon its RIIO-2 approach for RIIO-3. This includes setting rewards and penalties for the completeness and ambition (in terms of costs and outputs) of the business plan, with a lesser focus on quality where the assessment could be more subjective. Ofgem also proposes to strengthen, simplify and clarify the business plan guidance further. This incentive also encourages good justification of the proposed costs in the business plan.

Ofgem builds flexibility into the companies’ investment programmes through Uncertainty Mechanisms (UMs). Ofgem recognises that companies cannot accurately predict all future events such as changes in legislation, demand for work required or future costs. By using UMs, the revenue allowances can change in line with changes in requirements outside of company control. Ofgem proposes to continue using its range of UMs in RIIO-3 with modifications of specific UMs. The range includes UMs for cases when:

- the investment need or scope of project is uncertain;
- the quantity of future demand or costs is uncertain; or
- the investment need has been identified but the exact scope of the solution is unknown.

## Appendix 9 – Customer involvement

This appendix provides case studies of what other economic regulators require from regulated companies in terms of customer involvement.<sup>51</sup> The boxes below cover practices used by:

- Ofwat in their Price Reviews in 2014, 2019 and 2024;
- Ofgem in their RII02 price review for electricity distribution companies;
- ORR in their Periodic Review 2023 for Network Rail; and
- The CAA in their Heathrow Airport H7 price control.

### *Box 1: Ofwat's approach to customer involvement in PR14, PR19 and PR24*

## Ofwat's approach to customer involvement in PR14 and PR19

In Ofwat's price review in 2014 (PR14), Ofwat required companies to set up independent Customer Challenge Groups (CCG). The remit of the CCG was to:<sup>52</sup>

- test that the company has adequately understood and addressed its customers' priorities and needs;
- challenge whether the business plan delivers the right outcomes and levels of service at a price that customers are willing pay; and
- provide assurance to Ofwat on how well the company has engaged with its customers and highlighting any concerns.

The purpose of the CCG was to challenge the company's approach and response to customer engagement. It also provided Ofwat with assurance that the company business plan reflected a good understanding and reasonable balance of customer views. It was not intended to substitute for engagement with customers or negotiate on the business plan on behalf of customers.

Therefore, the CCG did not have a remit to agree the company's business plan or price limits on behalf of the generality of customers. Ofwat did not prescribe how companies were to set up or run the group, allowing companies to decide the membership, timings and work programme.

Ofwat's only requirement was for the group's chair to be independent of the company.

In Ofwat's lessons learned from PR14, Ofwat set out areas of good practice from the CCG reports in the following diagram.<sup>53</sup>

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<sup>51</sup> See also UK Regulators Network (2017), 'Consumer engagement in regulatory decisions', April 2017.

<sup>52</sup> Ofwat (2012), 'Information notice: Involving customers in price setting – Ofwat's customer engagement policy: further information', 20 April 2012.

<sup>53</sup> Ofwat (2018), 'Aide Memoire for Customer Challenge Groups', 21 March 2018, p.6.



One area of feedback from the CCGs was that some members of the CCGs identified the need for clearer and more accessible guidelines from Ofwat, to help focus efforts of the members.<sup>54</sup>

For PR19, Ofwat set out a very clear role for CCGs to provide independent challenge to companies and independent assurance to Ofwat on:<sup>55</sup>

- the quality of a company’s customer engagement; and
- the extent to which the results of the engagement are driving the company’s business plan.

Ofwat also set out that it was not the role of CCGs:

- To endorse the company’s overall plan.
- To provide assurance that all costs included in the company’s plan are efficient.
- To act as a substitute for a company engaging its actual customers.
- To substitute its views for those of customers.

Ofwat also specified that CCG chairs should not represent a particular organisation or group of customers and each CCG must include a representative from the Consumer Council for Water (CCW).

In reviewing CCG reports, Ofwat focused on two main factors:

- the evidence provided in the CCG report demonstrating how the CCG has carried out its role; and
- the strength and transparency of the governance arrangements in place.

<sup>54</sup> Ofwat (2015), *Reflections on the price review – learning from PR14*, 30 July 2015, p.21.

<sup>55</sup> Ofwat (2018), *Aide Memoire for Customer Challenge Groups*, 21 March 2018.

On this latter point, Ofwat set out that it would take more assurance from CCG reports of CCGs with stronger and more transparent governance processes in place and that the ability to demonstrate independence will play a role in the confidence Ofwat places on the CCG report.

## Ofwat's approach to customer involvement in PR24

For PR24, Ofwat identified areas that could benefit from collaborative research involving Ofwat, CCW and companies, including:

- Research on common performance commitments;
- Incentives; and
- Acceptability and affordability testing.<sup>56</sup>

Ofwat also introduced open challenge sessions ('Your water, your say'), which involved each company inviting customers and other stakeholders to challenge their plans in an open forum.

Ofwat required companies to hold two sessions:

- one session to be conducted during the development of the business plan, to allow companies the chance to revise plans to reflect views heard; and
- one session after final business plans, to allow companies to take account of views expressed.

Ofwat set out expectations on companies for these sessions, including that they would be independently chaired, that companies would prepare and publish a written record of the discussion and would need to demonstrate how it has reflected the views in their PR24 submission or directly to an attendee and that the participants are representative of a broad mix of the customer base.<sup>57</sup>

In its customer engagement policy for PR24,<sup>58</sup> Ofwat also set out expectations for what it considers high-quality research and the expectations for assurance of the quality and the use of customer engagement in business plans. Ofwat requires the assurance to be undertaken by independent expert(s) with no restrictions on reporting, which means:

- companies should not input to, or review, the assurance before it is issued, other than to check for factual accuracy; and
- assurance should contain clear statements and evidence that the process was conducted independently of the company.

Some companies have continued to use the CCG model to provide such assurance in PR24.

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<sup>56</sup> Ofwat (2021), 'PR24 and beyond position paper: Collaborative customer research for PR24', 27 October 2021.

<sup>57</sup> Ofwat (2022), 'Creating tomorrow, together: Our final methodology for PR24. Appendix 6 – Your water, your say', 13 December 2022.

<sup>58</sup> Ofwat (2022), 'PR24 and beyond: Customer engagement policy – a position paper', 24 February 2022.

## Ofgem's approach to customer involvement in RIIO-ED2

Ofgem regulates companies operating in the electricity distribution, transmission, and gas distribution networks through network price controls named RIIO, which stands for Revenue = Incentives + Innovation + Outputs. The most recent RIIO price control, RIIO-ED2, applies to the electricity distribution companies from 1 April 2023 until 31 March 2028. As part of their methodology, Ofgem required each company to establish an independently chaired Customer Engagement Group (CEG). The CEGs were required to provide a public report to the regulator with their views on their company's business plan, reflecting the perspective of local stakeholders.<sup>59</sup> The composition of each CEG was determined by the independent chair, rather than by Ofgem.<sup>60</sup>

Furthermore, Ofgem had established the RIIO-2 Challenge Group in 2018 which was also independently chaired and had the task to provide Ofgem with a public report on each of the companies' draft business plans, on behalf of existing and future customers (the end users).<sup>61</sup> The reports from the CEGs and the Challenge Group were considered by stakeholders during Ofgem's consultations and open public hearings on the business plans ahead of the Draft and Final Determinations.

The regulator's business plan guidance<sup>62</sup> also requires companies to evidence the following:

- the process for appointing CEGs;
- the company's effective engagement with the CEGs and Ofgem's Challenge Group;
- the company's robust and high-quality engagement with stakeholders while designing the plan; and
- the company's approach to ongoing stakeholder engagement.

Ofgem has issued specific guidance<sup>63</sup> on its enhanced engagement approach where it outlines the role of CEGs in the process, what areas the CEGs should focus on, what is within and outside their scope, and their governance arrangements.

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<sup>59</sup> Ofgem (2020), 'RIIO-ED2 Methodology Decision: Overview', 17 December 2020.

<sup>60</sup> Ofgem (2019), 'RIIO-ED2 Framework Decision', 17 December 2019 updated 23 January 2020.

<sup>61</sup> RIIO-2 Challenge Group (2020), 'RIIO-2 Challenge Group Independent Report For Ofgem On RIIO-2 Business Plans', 24 January 2020.

<sup>62</sup> Ofgem (2021), 'RIIO-ED2 Business Plan Guidance', 30 September 2021.

<sup>63</sup> Ofgem (2021), 'Enhanced Stakeholder Engagement Guidance for RIIO-ED2 - Version 2', 30 April 2021.

## ORR's approach to customer involvement in PR23

The Office of Rail and Road regulates the funding and monitors the performance of Network Rail in England, Wales and Scotland. ORR's latest Periodic Review for Network Rail is PR23 which applies for Control Period 7 (CP7) running from 1 April 2024 until 31 March 2029. The PR23 Final Determination is based on the regulated company's Strategic Business plan (SBP) which is the main source of evidence used for determining the funding and outputs for CP7. ORR provides only very high-level guidance on how Network Rail should engage with its stakeholders and how it should evidence that in its business plan.<sup>64</sup> At a minimum, the SBP should demonstrate how:

- Network Rail has undertaken analysis to map their stakeholders;
- Network Rail has considered stakeholders' views, including the governance process for reflecting their needs in Network Rail's decision-making;
- Network Rail has discussed with stakeholders how to prioritise needs and the resulting trade-offs;
- Network Rail has ensured their engagement process is accessible to and inclusive of all stakeholders; and
- Network Rail has provided feedback to its stakeholders regarding the outcome of the engagement and how their views have contributed to Network Rail's decision-making.

## CAA's approach to customer involvement in H7 price control review

The Civil Aviation Authority (CAA) is the economic regulator of airports and licenses those airports which have substantial market power. Heathrow Airport received its licence in 2014 (together with Gatwick airport) and has been subject to price controls since then. Heathrow's current price control period, H7, started on 1 January 2022 and will last until 31 December 2026.<sup>65</sup>

CAA's business plan guidance for H7<sup>66</sup> outlined high-level expectations for customer engagement which required Heathrow to:

- use an appropriate range of data and techniques;
- understand the needs and requirements of different consumers;
- engage consumers on complex issues by informing and educating;

<sup>64</sup> Office of Rail and Road (2022), 'Periodic review 2023: Guidance to Network Rail on the preparation of its Strategic Business Plan', 28 July 2022.

<sup>65</sup> Civil Aviation Authority (2023), 'Economic regulation of Heathrow Airport: H7 Final Decision – Summary', 8 March 2023.

<sup>66</sup> Civil Aviation Authority (2017), 'Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control', 27 April 2017.

- carefully design its willingness-to-pay studies to increase their robustness; and
- engage with consumers on an ongoing basis.

Similar to Ofwat's Customer Challenge groups (CCGs) and Ofgem's Customer Engagement Groups (CEGs), the CAA established the independent Consumer Challenge Board (CCB) in partnership with Heathrow airport for the duration of the H7 control period.<sup>67</sup> The CCB's role is to review and challenge the airport on the conduct of its customer engagement programme and on how the airport has interpreted and applied the programme's results in its business plan. In particular, the business plan guidance required CCB to report to CAA on whether:

- CCB was able to fulfil its role objectively, independently, and with full access to required information and resources from Heathrow airport;
- Heathrow airport implemented a robust customer engagement programme including effective communication to customers and accessibility to all customers;
- Heathrow airport genuinely incorporated the customer engagement programme results in its business plan;
- Heathrow airport translated consumers' expectations into outcomes, and how well it has evidenced that; and
- the outcome delivery incentives and targets are sufficiently challenging and aligned with consumers' interests.

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<sup>67</sup> Civil Aviation Authority (2016), *'Decision on the Terms of Reference for the H7 Consumer Challenge Board (CCB)'*, 20 September 2016.

## Appendix 10 – Other technical assumptions

This appendix sets out how we will estimate these assumptions, which we will revisit throughout the Strategic Review of Charges (SRC) process to ensure that the financial forecasts are as accurate as possible.

### BACKGROUND

For forecasting purposes, we require a set of assumptions in order to evaluate different scenarios and to assess the charge caps necessary for Scottish Water to deliver the Ministerial Objectives. Some of these assumptions are covered below, along with an initial view of how we might assess the appropriate value (or range of values) for them.

### REVENUE

The majority of Scottish Water's funding comes from household and non-household customer charges (see section 10.2). The revenue from these streams will depend on a number of factors including growth and discounts available to customers. These assumptions are covered below.

#### *Price inflation*

Real price effects will impact the buying power of the funds Scottish Water collects, particularly when looking over the longer term. As set out in chapter 11 we propose setting charges relative to inflation. In practice, as in previous regulatory periods, this will mean that customer charges are set relative to the Consumer Price Index (CPI) measure of inflation for October of the previous year. We use the previous October due to timing as it is the most recent at the time Scottish Water prepares its charges scheme submission for our approval, which typically happens in the December before the new charges take effect on 1 April of each year.

When CPI figures for the previous year are confirmed, they are published online by the Office for National Statistics (ONS). As for projections, we will consider the forecasts of authoritative sources. Typically, this will be the Bank of England, which publishes Monetary Policy Reports quarterly.

This index will be applied when forecasting the following profiles:

- Household revenue
- Non-household revenue
- Other revenue
- Infrastructure Charges Income (ICI)

#### *Household property growth*

When forecasting household revenue, we must consider the growth in household properties we expect to see over the period. However, since customers of Scottish Water are charged based on the council tax band of their property, we estimate the growth in unmeasured households based on

'Band-D equivalents' (where households in other council tax bands are converted into Band D equivalents based on their charge as a ratio of the Band D charge).<sup>68</sup>

To estimate this growth rate, we will examine historical time series whilst also taking account of any relevant forecasts from reliable sources at the time.

### *Council tax bands and discounts*

In Scotland, a large proportion of household customers receive a discount on their water and wastewater charges through the Water Charges Reduction Scheme (WCRS). While neither WICS nor Scottish Water have control over the value of this discount or who is eligible for it, we must understand the impact that any changes to the WCRS might have on Scottish Water's revenue if Ministers decide to change the level of discount or eligibility for a discount through their Principles of Charging for the industry.

### *Non-household property growth*

For the growth rate of the number of non-household properties, we will take a similar approach to household growth, using a combination of historical data and reliable external forecasts where appropriate.

As the majority of non-households are metered, their consumption will affect Scottish Water's revenue. We receive information on the volumes of water being used through the P tables of the annual return. We will use this to review historic trends in consumption (while recognising that consumption is likely to have changed – perhaps only temporarily – as a result of the Covid-19 pandemic).

## **OPERATING COSTS**

Scottish Water's operating costs remain relatively stable year on year. When forecasting operating costs, we will consider:

- the appropriate efficiency challenge to ensure that customers are not paying more than is necessary
- the inflation assumption based on published inflation index or indices for rolling forward operating costs; and
- the appropriateness of any other adjustments where required.

### *Operating cost inflation*

As the costs of goods and services will increase through the regulatory period, potentially significantly, we will assume that Scottish Water's operating costs will increase in line with inflation

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<sup>68</sup> For example, the Band H charge is 2 times the band D charge. As such, a household in a council tax Band H property is equivalent to 2 households in a council tax Band D property.

(before any assessment of efficiency or any other potential adjustments are applied). We expect these to be based on the published consumer price index inflation (CPI) for operating expenditure based on the average level of CPI over the financial year. We will consider the projections for CPI as per the Bank of England's latest forecast in its Monetary Policy Report.

## **PFI EXPENDITURE**

Scottish Water currently has seven active Private Finance Initiative (PFI) contracts. We plan to model these costs in a more granular manner than we have in previous regulatory periods.

### *PFI inflation*

PFI contracts in Scotland typically have contracted costs tied to an inflation index, though the specific index can vary between contracts. Most often these contracts are linked to the Retail Price Index (RPI) measure of inflation. We expect a published measure of inflation that most closely follows the inflation set out in the relevant contracts for PFI expenditure. If Scottish Water proposes to use RPI, we will consider the projections of other authoritative sources, such as the Office for Budget Responsibility (OBR), as an alternative, recognising that the Bank of England does not produce forecasts for RPI.

### *Expiry of PFI contracts*

Two of these PFI contracts are due to expire at the beginning of the SRC27 regulatory period. The current assumption is that the works will return to Scottish Water ownership/management at that point. We collect this information, along with the cost of each contract, in the annual return and regulatory accounts we collect from Scottish Water each year.

Due to economies of scale and operational advancements over the last 20 years, Scottish Water may be able to operate these assets more efficiently than the costs of the current contracts. However, these assets may require additional maintenance on return to Scottish Water. We will work with Scottish Water to understand the potential impact on costs from these assets returning to Scottish Water.

## **INTEREST PAYMENTS**

As discussed in section 10.2, Scottish Water takes on additional debt each year to fund a proportion of its investment. Scottish Water holds debt of approximately £4.7bn<sup>69</sup>, meaning that interest payments are of a material cost and need to be carefully considered when modelling. The main factors here will be the level of new borrowing available to Scottish Water, interest rates, and the maturity of existing loans.

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<sup>69</sup> £4.7bn of debt was held at financial year end 2023-24.

### *New borrowing*

Scottish Water borrows from the Scottish Consolidated Fund (SCF). The amount of borrowing is set by the Scottish Government in its Principles of Charging. The Commissioning letter for SRC27 indicates that, for planning purposes, we should assume that similar levels of borrowing available over SRC21 (£1.03bn over the 6 year period) will be made available in SRC27.

We will use several authoritative sources to assess an appropriate assumption for the interest rate to be applied to this borrowing.

### *Existing debt*

As part of the annual return and regulatory accounts, we collect information on existing debt Scottish Water holds. We collect this data at a granular level, with data being collected on each individual loan. This data includes:

- Drawdown date
- Maturity date
- Principal
- Interest rate

We will use this data to forecast future interest payments. The maturity date, principal and interest rate can be used to calculate the amount of interest due on each existing loan in any given year. It will be assumed that on the maturity of a loan, the principal will be reborrowed at the same interest rate as any other new borrowing in the year.

## **TAXATION**

Corporation tax payable is a function of UK Government policy and Scottish Water's pre-tax profits/losses, investment allocations to depreciation pools, depreciation rates, corporation tax rates, and brought-forward losses from previous financial years. We will continue to work with Scottish Water to understand the materiality of any potential tax liability it might face in the future.

## **CAPITAL EXPENDITURE**

Chapter 14 sets out in detail our approach to capital expenditure for SRC27. There are, however, additional assumptions to consider. These are covered below.

### *Capital inflation*

We expect Scottish Water to use a published measure of capital price inflation for investment that Scottish Water considers closely follows the capital price inflation that it observes. We consider that there is scope for Scottish Water to examine the merits of indexing capital projects to the new infrastructure construction output prices index (COPI), which Ofwat is now proposing to adopt for the water and wastewater companies in England and Wales. The ONS publishes outturn data for COPI, and we can see that, typically, COPI runs higher than CPI. We will use this publicly available

data from the ONS as well as any relevant forecasts available at the time to assess an appropriate assumption for capital price inflation going forward.

### **CASH BALANCE**

Scottish Water holds a cash balance to mitigate short-term shocks, but as mentioned above, the cash balance will also reflect timing differences between revenues and expenditures. We will work with Scottish Water to assess the appropriate level of cash it should hold, recognising that it could need access to cash reserves in the event of an unexpected cost shock.

Scottish Water can earn interest on its cash balance. Our assumption for the interest rate applied to cash balances will be considered using an approach in line with the approach for other assumptions—a combination of reviewing historic trends observed through the data we receive from Scottish Water and analysing any other authoritative sources available to us at the time.



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