

2 Context and background

Since the initial regulatory framework in Scotland was established in 1999, the economic regulation of the water sector in Scotland has evolved considerably to address changing objectives and involve new actors. This chapter provides an overview of the market structure of the sector, the actors involved in economic regulation, and the regulatory approach over time.

Market structure

Water and wastewater services in Scotland's household market are provided by Scottish Water, established in 2002. Scottish Water is the monopoly provider within the household market. In the non-household market, liberalised in 2008, Scottish Water's ring-fenced retail subsidiary Business Stream competes with other providers (Scottish Parliament, 2005^[1]). Scottish Water is a public company with the Scottish Government as its sole shareholder. It replaced the three former regional water authorities in a move aimed at addressing systemic inefficiencies and providing harmonised charges across Scotland. These market arrangements for water and wastewater services differ from those that apply to the rest of the United Kingdom.¹

Scottish Water provides water and wastewater wholesale and retail services to around 2.3 million domestic customer and wholesale services to around 140 000 businesses and public bodies. Scottish Water is fully funded by charges paid by its customers. It is also able to access appropriate borrowing from the Scottish Government.

The vast majority of households pay their water charges to their local councils, based on council (property) tax bands rather than on metered consumption. Household meters are limited to a small number of households that have requested and assumed certain installation costs to measure and bill based on consumption (Citizens Advice Scotland, 2021^[2]). Charges are broadly cost-reflective between broad categories of customers (Hendry, 2016^[3]) although there is undoubtedly cross-subsidy between urban and rural customers and across geographic areas. The average household bill was GBP 372 in 2020/2021, although there is considerable variation between the charges of the lowest and highest council tax bands (Scottish Water, 2020^[4]). In the same financial year, Scottish Water's annual revenues were GBP 1 667 million. Scottish Water's net new borrowing during this year amounted to GBP 219 million and its capital programme is more than GBP 600 million per annum in current prices (Scottish Water, 2021^[5]).

Key institutions

When determining the limits on charges that customers pay for Scottish Water services, the Scottish Government and WICS are key actors. The Scottish Government initiates each Strategic Review of Charges, providing the overarching principles and objectives that frame the SRC process. WICS, the economic regulator for water and wastewater services in Scotland, delivers a final determination that is in keeping with these Principles of Charging and Ministerial Objectives.

A number of Scottish institutions play a role in the price review process and the oversight of the sector. Water quality regulation and environmental regulation are performed by the Drinking Water Quality Regulator (DWQR) and the Scottish Environmental Protection Authority (SEPA). In addition, Citizens Advice Scotland (CAS) as the statutory body advising consumers plays an important consultative role in the price-setting process. While none of these bodies have a statutory role in price setting, all of these bodies have played an advisory role in SRC21. Their formal roles intersect with the economic regulation during the definition of needs and monitoring of delivery. They have a role in the development of the Ministerial Objectives (through a Scottish Government led process termed "Quality and Standards"). In addition, WICS, DWQR, SEPA and CAS work with the Scottish Government to monitor Scottish Water's delivery of the objectives and related outcomes, previously as part of an Output Monitoring Group which has been reformed as a Delivery Assurance Group for SRC21. These bodies' roles are summarised in Annex A.

An evolving regulatory approach in the Scottish water sector

The regulatory approach in the Scottish water sector has evolved over time from what was perceived as a more adversarial model to one seen as more collaborative, enabled by improvements in performance. Initial periods of adversarial and contested settlements were demanding and resource-intensive processes. Through successive price reviews, as information sharing and performance improved, the scope for disputes reduced and the adversarial nature of the process could evolve towards a more collaborative settlement. At the beginning of the journey, benchmarking analysis played an important role to promote efficiencies. However, the regulator observed that efficiency comparisons progressively became less effective, especially as performance indicators converged over time. With benchmarking no longer providing the same incentives, competition-like pressure needed to be exercised through different means.

In the case of Scotland, the regulatory “journey” has moved in stages, from:

- an initial position of maintaining a traditional regulatory distance with a degree of scepticism about drivers and performance;
- into a more adversarial and sceptical relationship caused by a perceived lack of progress in delivery and incomplete and at times inconsistent information which led to a lack of trust;
- then to an adversarial but more trusting relationship when robust information sharing was established and traditional regulatory tools could be employed, and;
- finally to a collaborative and trusting relationship where performance had improved to a point that the traditional regulatory tools had served their purpose and a new approach was required.

The regulatory process between 2002 and 2015

When the initial regulatory framework in Scotland was established in 1999, there were two clear challenges – to close the considerable efficiency gap with privatised companies in England and Wales, and to meet nationally and internationally required water quality and environmental standards. A regulatory framework featuring close monitoring and performance benchmarking, adapted from the regime for privatised water and sewerage companies in England and Wales, promised rapid and significant improvements in the newly-established Scottish Water. The framework soon gave way to one that closer resembles today’s model, adding an independent Commission with the power to determine charges and develop incentive-based regulation.

This period marks the first use of enhanced consumer representation in the economic regulation of the water sector in Scotland. The independent organisation Waterwatch Scotland was established to represent customer views, with the ability to make complaints about water and wastewater providers. The organisation was short-lived; it disbanded in 2010 as part of the re-organisation of consumer representation in Scotland. The Scottish Public Services Ombudsman absorbed their complaints function, while Consumer Focus Scotland inherited their representation function. During the same period, WICS started to consult directly with stakeholders on the company’s business plan, using consumer representative bodies’ research as an input, and the draft determination, where groups served as statutory consultees.

Outcomes and limitations

During this period, the evolving regulatory framework accomplished its goals of improving Scottish Water performance. Scottish Water transformed itself as an organisation, catching up with the top performing companies in England and Wales on cost efficiency and levels of service. Since 2005, the company regularly reached – and outperformed – its targets. Charges increased at around the rate of inflation during this period, while customer service levels increased significantly.

In its thinking about the lessons for future price reviews, the economic regulator soon realised that its approach should evolve to reflect these improvements in performance and encourage quality stakeholder engagement. As the relationship between the regulator and Scottish Water increasingly allowed for exploring challenges through constructive dialogue, the regulator hoped to move away from the traditional “parent-child relationship” (WICS, 2013, p. 19^[6]). WICS also acknowledged that highly technical stakeholder workshops were inaccessible to many customers and representatives, and that customers struggled to put WICS decisions and documents in context to understand impacts on their services or charges (WICS, 2013, p. 27^[6]). Exiting this early phase of regulation, WICS identified the need for the regulator-company relationship to evolve and the need to facilitate meaningful consumer engagement.

The Strategic Review of Charges 2015-2021 (SRC15)

The regulatory approach in SRC15 would tackle these two needs head-on, allowing greater flexibility for the company’s investment programmes and incorporating more substantial consumer inputs. The improvement in Scottish Water’s financial performance, levels of service and compliance throughout previous reviews of charges enabled these changes. In addition, the company was approaching a regulatory plateau, meeting a relatively stable set of standards, in a relatively stable environment, with low inflation and minimal price increases. In this context, benchmarking improvements and benchmarking against English companies had limited usefulness (Littlechild, 2014^[7]). Instead, as argued by Hendry (2016^[8]), “identifying, and meeting, the wishes of customers becomes more important, around discretionary spend and around the phasing of improvements’ (Hendry, 2016, p. 10^[8]). To provide further challenge and exert further competitive pressure on Scottish Water, WICS introduced new changes in this regulatory period that offered flexibility in business plans and an enhanced customer voice in the process

The regulatory approach

WICS made a number of other significant changes to the regulatory approach ahead of SRC15, such as allowing greater flexibility and adopting a longer-term view. First, WICS abandoned the prescriptive framework used in the past in favour of a more flexible approach. The Commission did not provide detailed guidance and templates for Scottish Water to complete in its business planning, allowing the company to produce a more strategic, customer-oriented business plan (WICS, 2013, p. 22^[6]). Second, WICS required Scottish Water to adopt a long-term view. It further extended the formal price review period from five to six years, and asked the company to draft a 25-year strategic vision document estimating the resources the company would need to achieve long-term objectives, with the expectation that Scottish Water’s 6-year business plan would be aligned with the strategic vision. In parallel, the regulator saw the updated regulatory framework as an opportunity to provide assurance that Scottish Water would be financed sustainably in the interest of both current and future customers (WICS, 2013^[6]). As part of their guidance, WICS therefore introduced a set of “financial tramlines”² to indicate to Scottish Water and its regulators whether it would be outperforming, or underperforming, in cash and capital value terms. The tramlines provided the possibility of “rebalancing” during the regulatory period while still reflecting the spirit of the agreement between the Customer Forum and the company (Littlechild, 2014, p. 15^[7]).

Consumer engagement

WICS sought to elevate the voice of customers in the regulatory process, providing a strong alternative driver for improvements as technical benchmarking became less useful. Inspired by the UK Civil Aviation Authority (CAA) constructive engagement model and negotiated settlements in the United States and Canada, WICS solicited stakeholder and expert views on creating a new body to represent customers’ views. While all stakeholders were supportive of the idea, each had their own reservations. Scottish Water was not fully convinced that it had to do more to legitimise its business plan – particularly as its reported performance had improved markedly. Scottish Ministers and Government officials worried about the

legitimacy and representativeness of the proposed body. Consumer bodies were unclear about role allocation across policy and regulatory issues (Littlechild, 2014^[7]).

Despite initial concerns, WICS, Scottish Water and the National Consumer Council reached an agreement to create the first “Customer Forum” and detailing the roles, timeline and composition of the group. This provided the necessary certainty that the newly established body would be an integral part of SRC15 and built confidence with stakeholders about the role of the Customer Forum. However, the Forum was created for the purpose of SRC15 only and without making any statutory changes to the regulatory process, in order to retain some flexibility and consolidate the progress made in previous SRCs.

The Forum’s remit expanded from the role established in the formal agreement, and WICS’s eventual expansion of its role demonstrated the dilution of the adversarial regulatory relationship between Scottish Water and WICS. The agreement gave the Forum the role of working with Scottish Water on a programme of research in order to establish customer priorities for service level improvements, understand and represent those priorities and preferences to WICS and Scottish Water, and ensure the most appropriate outcome for consumers based on those priorities and preferences. Soon, WICS formally expanded the Forum’s role to include negotiating Scottish Water’s entire business plan with the company. WICS shared its views on possible ranges for all of the key inputs before the Forum negotiated the business plan with the company. WICS did not formally commit to accepting or incorporating any agreement or views in its final determination (Littlechild, 2014, p. 6^[7]) but did indicate that they would be minded to accept an agreement between Scottish Water and the Customer Forum that fell within the ranges that had been set.

The Forum’s composition reflected the group’s role as a conduit for customer views in the SRC based on evidence, rather than a representative group. It was charged with, among other attributions, “[u]nderstanding and representing to the Commission and to Scottish Water the priorities and preferences of customers (as a whole) in the SRC 2015-2020 process as identified through the customer research” (WICS, Scottish Water, and the National Consumer Council, 2011^[9]). Led by a chair jointly appointed by the parties to the agreement, the group did not claim to be representative of household or business customers, consisting of five ordinary members with “strong customer focussed reputation”, two ordinary members from the largest service providers in the country, and one ordinary member from the Scottish Council of Development and Industry. The chair received an annual sum commensurate with a commitment of 90 days per financial year and all other members committed to 50 days per financial year, funded by WICS.

A negotiating team from the Forum and Scottish Water entered into a Minute of Agreement in 2014, building upon an iterative process of negotiations in previous years. Informed by WICS’s notes and research, the Forum and Scottish Water began to agree on a number of priorities around service quality levels, investment and customer service throughout 2012 and 2013. Scottish Water published its long-term strategic projections in October 2013. There was some involvement of SEPA and DWQR in providing clarification around quality requirements and the budgets needed to achieve those requirements. When the Forum and the company signed the Minute of Agreement after twelve hours of negotiation, it marked the Forum’s approval of Scottish Water’s business plan for 2015-2021. WICS adopted a determination consistent with the Minute of Agreement, formalising its acceptance of the result of negotiations.

Box 2.1. The role of consultative bodies in the regulatory decision-making process at Portugal’s Energy Services Regulatory Authority (ERSE)

ERSE’s Statutes form the foundation for the regulator’s inclusive and transparent decision-making approach, through the creation of three consultative bodies (known as councils), which contribute to the development of its technical regulations, tariff decisions and the broad lines of action and deliberations

taken by ERSE's Board of Directors. The three consultative councils – Advisory Council, Tariff Council and Fuels Council – act as a forum for creating consensus among key stakeholders.

As part of a broader consultation and engagement policy, the councils issue non-binding opinions on ERSE's regulatory proposals. Importantly, where the regulator does not take on board the opinions presented by the councils, it must justify in writing why it has not adopted the council's proposed changes. Together with ERSE's other engagement mechanisms, this process ensures accountability and strengthens the integrity of the regulator's decisions. In addition, they provide a permanent platform for stakeholders to meet and understand each other's perspectives. In this way, the councils provide stability to stakeholders and achieve consensus in their statements in an impressive 90% of cases.

The councils are composed of a broad spectrum of representation from national, regional and municipal government, consumer organisations and the energy industry. Council members serve a non-remunerated and renewable term of three years. Each council decides how often to meet in order to prepare its opinions. Generally speaking, and in response to the increased activities and responsibilities of the regulator, the councils may meet several times a month. All opinions of the councils are approved by majority vote, although if members do not agree with all or parts of the opinion of the council they can state this in the submission to ERSE. The opinions of the councils are made public and published on the ERSE website.

More specifically, as regards tariffs and prices, in line with a timeline fixed by law, ERSE must submit its draft proposals to the Tariff Council, which delivers non-binding opinions on the review and approval of the tariff codes, as well as on the annual determination of tariffs and prices. The plenary and sectoral sections of the Tariff Council (electricity section and natural gas section) are chaired by a person of recognised standing and independence appointed by the member of the Government responsible for energy.

Given the characteristic asymmetry of information and resources between the industry and consumers, ERSE seeks to facilitate the latter's engagement in a number of ways. First, industry and consumer representatives must be represented in equal numbers. Second, ERSE provides a subsistence and attendance allowance for consumer representatives, as well as for government, public bodies and representatives from Azores and Madeira. In addition, ERSE provides training to the household consumer associations that sit on its consultative councils in order to build their capacity and ability to contribute to deliberations.

Source: Information provided by ERSE, 2022.

Key outcomes of an evolving regulatory process

The more flexible, customer-centric approach to water regulation in SRC15 has been praised as one of the most “innovative, successful and encouraging developments in UK utility regulation” (Littlechild, 2014, p. 177). The *ex post* reviews undertaken and the feedback collected from industry stakeholders highlight that:

- By being asked to negotiate the business plan with the provider, the Customer Forum was delegated real power from the economic regulator, which however retained the position of final arbiter and contributed to the final settlement by providing key guidance and technical information to the Forum.
- Scottish Water's understanding of what customers want appears to have improved, thanks to the new framework pushing the company to assess customer needs more in-depth and to provide a more careful examination of the rationale for its investment plans.

- Negotiated prices were perhaps lower than they would have been under a traditional regulatory framework; in exchange for this concession, Scottish Water was able to plan future investment and operations earlier on by reaching a timely agreement and to embed elements of flexibility in its business planning.

Institutional innovation: The Customer Forum

The introduction of the Forum changed the roles and approaches of both WICS and Scottish Water during SRC15. To provide the necessary inputs for the Forum, WICS had to adopt a more strategic role in setting expectations around a number of parameters and assumptions very early on in the process. Its analytical focus shifted accordingly from somewhat static assessments of efficiency to more forward-looking analyses of high-level challenges. Those higher expectations have influenced Scottish Water, encouraging the company to better understand what customers want and pushing it to think more carefully about the rationale for its investment.

The new regulatory framework gave a prominent role and operational freedom to the Forum, while clearly defining the parameters within which the Forum could negotiate with Scottish Water to agree upon a business plan. While these processes placed restrictions on the negotiation, the Forum still had the opportunity to challenge and test the views of both the regulator on the ranges for key parameters and the company on assumptions for setting charges and prioritising investment. While the Forum conducted only limited customer research, it showed some ability to interpret research inputs critically and prompt some research into customer views.

Moreover, Forum members gained WICS's support to negotiate the entire business plan with Scottish Water while not having any obligation to find an agreement and knowing that WICS would be the "decision-maker of last resort". As a result, they felt empowered to exert pressure on a wide range of issues within the designated "safe space" in the framework. It is worth noting that "the operational freedom that the Forum seized as an opportunity could well have turned into a weakness, as it could have resulted in lack of focus and poor effectiveness". In fact, "some members had some initial misgivings about the absence of a clear direction of travel or detailed process" (Customer Forum, 2015, p. 22_[10]).

A legacy report recording observations from the first Forum also recognises that the consumer engagement and regulatory approach to SRC15 further contributed to a shift away from the adversarial nature of the price determination and towards a more accessible model. It presented a more constructive approach aimed at "finding acceptable compromise", putting the customer "at the heart of the decision-making process", and increasing the transparency of decision making by making Scottish Water's documents (including the business plan) more accessible to a non-technical audience (Customer Forum, 2015_[10]). Littlechild (2014_[7]) notes that the regulatory documents are more understandable, more accessible and substantially shorter than in previous SRCs.

These positive outcomes did not come about without obstacles. Some of the Board members in the Commission initially felt uneasy about the perceived delegation of statutory responsibilities from the regulator to the Forum and they maintained some reservations during the discussions about the future of the Forum post SRC15. Within Scottish Water, the CEO and senior management were heavily involved in gaining internal buy-in for this new approach in light of the perceived benefits to the way the company operated.

Customer views at the centre of the Final Determination of Charges

Stakeholders in the Scottish water industry agree that the new process was instrumental in driving a far greater focus on customers, reflected in the parameters and commitments contained in the Final Determination of Charges adopted by WICS.

New parameters

Exchanges between the Customer Forum and Scottish Water led to an agreement that sketched the trajectory of charges over the regulatory period. The negotiation of charges for the six-year period 2015-2021 was influenced by the Forum's research on the impact of the economic crisis on affordability and the need to keep prices low in light of decreasing real incomes. The final determination fixed an upper limit for Scottish Water's charges over the entire period, setting the overall tariff cap for household customers over the six-year regulatory period was set at no more than CPI minus 1.8%. It established a cap in nominal prices over the first years of the regulatory period, and allowed increases for remaining years relative to inflation. For the non-household market, WICS decided to freeze default tariffs for non-household customers in nominal terms for six years.

The parties agreed a price cap in constant nominal prices (irrespective of inflation) for the last year of the previous regulatory control period and the first three years of the 2015-2021 period. For this period, charges were set to increase by 1.6% per year in nominal terms. The nominal value was chosen with the intent to provide greater certainty to customers and better transparency as to what the price increases would mean. In this instance Scottish Water accepted a higher risk, however, in the context of a low inflation environment.

The regulator would still establish price increases for the remaining years in the regulatory period relative to inflation. This time, the regulator and the Government agreed to use CPI (consumer price index) instead of RPI (retail price index). The former is a measure that is more closely aligned to the perception that consumers have of price trends in the economy and is more easily understood. For the following three-year period, prices would rise at CPI minus 0.3%, subject to the overall requirement.

In addition, the Customer Forum agreed "a higher level of capital efficiency with Scottish Water than the economic regulator could have required using available benchmarking techniques". In this respect, the Forum's key message was that if the company carried any inefficiency, customers would not pay for it. The Forum's scrutiny of the rationale for investment programmes resulted in Scottish Water having to justify and reassess its investment propositions in more detail than was previously the case, finding ways to meet objectives in manners that are more efficient (WICS, 2014^[11]).

New approaches to innovation

WICS also introduced changes aimed at encouraging the use of innovative solutions. First, WICS allowed Scottish Water to factor in costs of any additional risk to the underlying cost of meeting a defined outcome. This measure was based on the recognition that innovation will inevitably result in some failures. By allowing an additional provision for risk, Scottish Water would be given the resources to resort to more traditional solutions in case of failure. To take up this risk-adjusted cost approach, Scottish Water would have to demonstrate that the total cost of the portfolio of projects (including the costs of the risk adjustment) would be lower than that of the next best alternative (WICS, 2017^[12]). Scottish Water and the Customer Forum agreed to ring-fence the additional risk allowance in a "risk reserve" to ensure that Scottish Water always had the cash resources it may require to deliver the required outputs efficiently and effectively.

New performance measures

Three new performance measures were developed by Scottish Water and the Customer Forum for introduction in the six-year period 2015-2021. As described in the Final Determination (WICS 2013), these measures are:

- the household customer experience measure;
- the non-household customer experience measure; and
- the "high esteem" test.

Similar to the Service Incentive Mechanism developed by Ofwat in England and Wales, the household customer experience measure is built from a quantitative and a qualitative component. The new measure is also the first performance measure to include the views of customers who have experienced an issue with their service but did not make direct contact with Scottish Water.

A similar measure is also being developed for non-household customers. These will help customers and other stakeholders to compare the service that is provided by Scottish Water year on year and, potentially, with services provided by other water and sewerage companies.

The high esteem test is used to compare Scottish Water's reputation among the public with those of other UK utilities,³ and also with the country's most trusted companies and brands across all sectors.

The key areas of focus going into SRC21

SRC15 had started a paradigm shift that would put a clear onus on Scottish Water to take ownership and demonstrate that it is focused on delivering for customers. This paradigm shift also brought to the fore a number of areas that would need to be developed further in the SRC21 and on which WICS started reflecting in preparation for SRC21.

The overall issue of asset maintenance and replacement had been an underlying theme SRC15. Innovative measures had been introduced to ensure that resources would be appropriately set aside and used to ensure that quality water would continue to “run through the tap”. However, there was also the realisation that Scottish Water might not yet have all the necessary capabilities to make the best informed decisions on the state of the assets. Scottish Water's ownership would also mean a shift in the organisational culture of Scottish Water, including in being proactive in identifying and alerting on current and future risks.

SRC15 had put a strong focus on eliciting the views of customers and ensure that these views were reflected in regulatory decisions. The Customer Forum had been one of the conduits of these views. The Forum was reinstated and set up earlier than for SRC15 with a partly renewed composition. Half of the previous members (including the Chair) were retained to guarantee some experience and continuity. The balance between members drawn from the wider public and from the water industry was marginally shifted towards business customers (water providers Business Stream, Anglian Water and Veolia each have a member on the Forum). Members of the public were selected through an open tender procedure managed by the Consumer Futures Unit of Citizens Advice Scotland. WICS also provided the Forum with a larger budget for SRC21 compared with SRC15. WICS also tried to support the use of innovative methods to elicit the “true” preferences of customers, including by exploring the use of behavioural sciences. This effort would lead to establishing a research coordination group between the Customer Forum, Consumer Futures Unit and Scottish Water (with WICS and the Scottish Government as observers) to coordinate research efforts and share outputs as they emerge.

Finally, to facilitate a shift towards open collaboration in line with the principles of ethical business regulation, WICS also started thinking of ways to facilitate continuous dialogue among all stakeholders from the beginning of the process. Starting as informal meetings triggered by the first OECD peer review of SRC21, these meetings evolved into joint stakeholder meetings with all actors in the Scottish water sector, to take place regularly throughout the process.

As the SRC21 unfolded, a number of challenges emerged that informed the process and partly determined its outcome. These key challenges with the way in which they were initially addressed and how they evolved throughout the process will be discussed in the following section.

Notes

¹ The Water Act 1989 privatised the water industry in England and Wales.

² For a detailed description of financial tramlines see WICS 2017a, pp. 67-69

³ Based on the UK Customer Satisfaction Index (CSI). More details at:

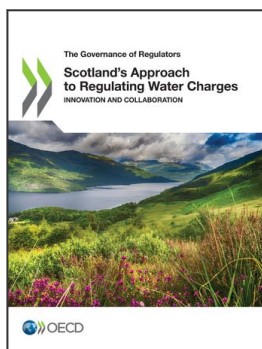
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[9]



From:
Scotland's Approach to Regulating Water Charges
Innovation and Collaboration

Access the complete publication at:
<https://doi.org/10.1787/fcc8c6df-en>

Please cite this chapter as:

OECD (2022), "Context and background", in *Scotland's Approach to Regulating Water Charges: Innovation and Collaboration*, OECD Publishing, Paris.

DOI: <https://doi.org/10.1787/354042ce-en>

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