

Annex A. Regulator decision papers

Through regular decision papers, WICS communicates its evolving understanding and expectations for the regulatory process. Between June 2017 and February 2020, WICS published a series of Decision Papers outlining its views on key parameters for the Strategic Review of Charges. The Decision Papers “sought to build a common understanding of the key regulatory inputs and the likely challenges the industry will face in 2020-21 period and long into the future” (WICS, 2020^[1]). These papers, published on the regulator’s website, served to provide technical information to the stakeholders involved in the SRC.

The first batch of thirteen Initial Decision Papers was published between August and October 2017. They touched on a wide-ranging set of issues and put forward various options to address them, both in the current SRC and beyond. Initial Decision Paper 2 made clear that Scottish Water would likely have to invest more in future regulatory periods (WICS, 2020^[1]). The Initial Decision Paper 7 on sustainable asset maintenance highlighted one of the key issues, discussing the challenge that Scottish Water invests sufficiently in maintaining its asset base both in SRC21 and into the future.

Throughout 2018, the Commission published eight Revised Decision Papers which reaffirmed and codified some of the key principles set out in the Methodology, but also captured the evolution joint stakeholder understanding of the issues as multilateral meetings continued. Based on the feedback received on its Revised Papers and the new Commissioning Letter from June 2019, WICS has adopted a more iterative and consultative approach to the drafting of its Final Decision Papers.

In summary, each of the 2018 revised decision papers addressed the following:

- DP1 provided the Commission’s comments to Scottish Water’s Strategic Projections
- DP2 confirmed the key macroeconomic assumptions outlined in 2017, while recognising that economic uncertainty may require changes in the Final DP.
- DP3 outlined the Commission’s expectations around the new investment planning and prioritisation framework required to appraise new investment
- DP4 established a set of expectations in relation to meeting the long-term investment challenge, providing Scottish Water with a list of key questions to think about in relation to developing trust in its new approach to investment
- DP5 focused on a coherent financial approach to capital maintenance, noting that it was very positive to see Scottish Water engage with stakeholders regularly on this issue. It asked Scottish Water to consider the possibility of “ring-fencing” a portion of its allowed revenue, setting this aside for investment pending assurance that the investment would be delivered efficiently and effectively and consistent with addressing the long-term asset challenge.
- DP6 outlined the Commission’s expectations on performance reporting, highlighting that greater visibility and transparency of performance can enable Scottish Water to build the trust of customers, communities and other stakeholders
- DP7 confirmed that the Commission expected Scottish Water to use the financial tramlines approach for its recurring expenditure
- DP8 provided a first opportunity for the Commission to write that charges would likely have to increase above the rate of CPI inflation during the following two regulatory control periods

The suite of 2018 decision papers was followed by one 2019 decision paper on asset replacement, and a 2020 final decision paper on prices.

WICS's decision paper on asset replacement

WICS published its Decision Paper on asset replacement challenge in July 2019. This Decision Paper reaffirmed the importance of Scottish Water being sufficiently funded in order to undertake the investment that it needs to make improvements in water quality, environmental compliance and meeting the climate change challenge.

The paper developed earlier positions by WICS on the need to replace assets in light of Scottish Water's net zero targets. In order to do so, it recognised that priority investment should go forward expeditiously and that replacement of medium life assets should take between 8-16 years. It also aligned 2045 as the target year for a smooth transition that takes into account both the replacement of long-life assets and the net zero targets.

This paper benefited from emerging analysis of asset conditions and lives by Scottish Water – WICS praised the company for their continued efforts in these areas and encouraged them to pursue the asset management improvement plan.

Final decision paper: “Prospects for Prices”

WICS' Final Decision Paper, “Prospects for Prices,” summarises WICS' views on the appropriate range for charge caps for the upcoming regulatory period (WICS, 2020^[1]). Based on the latest DP8, the Commission prepared a draft version of the final Decision Paper on prices and presented this to stakeholders in February 2019 as a slide pack for discussion. The Commission's modelling of asset lives, enhancement needs, growth forecasts and the scope for efficiencies led to an estimated allowance for investment (in growth, replacement and enhancements) of between £870 and £1020 million a year (in 2017-18 prices).

The final version of the paper concluded that average annual charges must increase by between 1% and 2% above CPI inflation to deliver this scale of investment, with an increase in the upper half of that range being most consistent with the magnitude of the long-term challenges facing Scottish Water. It asks the Customer Forum to negotiate with Scottish Water on three issues: investment, an efficiency challenge, and an allowance for potential additional cash outlays for the successful inclusion of emissions in appraisals. It defines the ranges for discussion of each:

1. Targeted annual investment of between £1.0 and £1.1 Billion (in 2017 prices) by 2040.
2. An annual efficiency challenge of between 0.75% and 1.5% for Scottish Water's expenditure on operations (including repairs and routine maintenance), financing and PPP management.
3. An allowance for the potential additional cash outlays (from £0 million to £150 million annually) that could result from including emissions in appraisals (WICS, 2020^[1]).

The Commission also regarded that a transition over at least three regulatory control periods would lead to a point where Scottish Water has an appropriate level of annual investment funding to meet those needs. Those funding needs and the estimated transition period translate into a price increase of between 2.7% and 2.9% in nominal terms (0.7% and 0.9% in real terms) for a period of up to 23 years.

In a subsequent meeting (Stakeholder Advisory Group, March 2019) the Commission presented different scenarios of the prospects for future prices in response to comments received from stakeholders. The 'base case' confirms the price ranges and the length of the transition first presented in the slide pack. However, five other scenarios show how prices may be lower or higher depending on the enhancement spending allowed. In all cases, prices would rise above inflation. Scottish Water would be subject to an efficiency challenge of between 1-1.5%.

The paper also stresses the transformation necessary for Scottish Water to meet the dual challenges of net zero emissions and asset replacement. WICS stresses Scottish Water's role in its own transformation and its ownership over its own strategy. It emphasises the importance of evidencing change in the absence of the traditional hard budget constraint to provide stakeholders confidence that the company is making progress towards long-term goals. It notes that Scottish Water should establish a transformation plan to evidence the change within its organisation.

References

- Consumer Futures Unit (2018), "Untapped Potential: Consumer Views on Water Policy", [2]
<https://www.cas.org.uk/publications/untapped-potential-consumer-views-water-policy>.
- WICS (2020), *Prospects for Prices Strategic Review of Charges 2021-27 Final Decision Paper*, [1]
<https://wics.scot/system/files/publications/Prospects%20for%20prices.pdf>
(accessed on 6 July 2022).

The Governance of Regulators

Scotland's Approach to Regulating Water Charges

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The price regulation conducted by economic regulators is a high-stakes process, with significant and lasting impacts on current and future service quality and the overall performance of the regulated sector. This report tracks the efforts of the economic regulator of the Scottish water sector to make the results of its price-setting process work better for the customers of today and tomorrow, addressing issues such as customer engagement, sustainable asset management and climate change. Based on the results of a multi-year peer review, it analyses the process and outputs of the price setting process. It also sets out recommendations to help parties strengthen the resilience and stability of the regulatory framework while not losing sight of strategic vision and objectives.

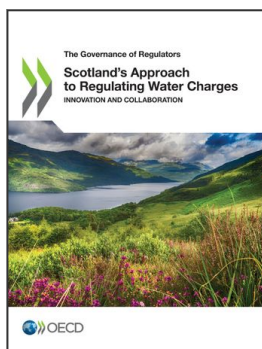


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