

From [REDACTED]  
Water Industry  
6 July 2020

Cabinet Secretary for Environment Climate Change and Land Reform

## **SCOTTISH WATER – STRATEGIC REVIEW OF CHARGES 2021-27**

### **Purpose**

1. This submission seeks your views on how to take forward the Strategic Review of Charges in the light of the issues raised by COVID-19 and the advice of the Water Industry Commission for Scotland (WICS).

### **Timing**

2. Routine.

### **Summary**

3. Having reviewed the WICS advice and the wider context, it is proposed

- The final determination should be published by the WICS in December;
- The regulatory period should remain as previously planned at 6 years. Whilst this contradicts WICS advice as set out in their letter, in fact thinking has moved on and a different way of ensuring the long term stability of investment and charging that was sought with a longer regulatory period has been promoted - WICS and other stakeholders are comfortable with the proposal. In short, it means adopting a rolling investment programme with regular charge and investment forecasting;
- The WICS should be invited to set out prospective charges for the following period and up to 2040 on the basis of stated assumptions and with reference to an identified investment target;
- Increasing support for those facing difficulty paying by increasing support through the Water Charges Reduction Scheme will be proposed when advice on Principles of Charging comes forward;
- As much account as possible, within the timetable for the determination and for setting charges for 2021-22, should be taken of relevant factors including the impacts on Scottish Water of COVID-19, the wider economic circumstances, the understanding of the circumstances of households, the future trajectory of council tax and other burdens on households;
- In setting charges for 2021-22 Scottish Water should take all relevant factors into account.

4. A draft letter is attached responding to the WICS and setting out this approach at Annex B.

## **Background**

5. When the COVID emergency struck, the Strategic Review of Charges (SRC) by the Water Industry Commission for Scotland (WICS) was at an advanced stage. The WICS had published Prospects for Prices in February, setting out their view of the implications for the trajectory of charges over the next regulatory period and indicatively beyond. Year on year real term charge increases of 1.5-2% throughout the period are considered necessary to finance the increased levels of investment that Scottish Water will require. That investment is driven largely by the need to address the aging asset base and to make progress towards the commitment to net zero emissions by 2040.

6. The original SRC timetable envisaged that, following further discussion between Scottish Water and the Customer Forum, the WICS would make a draft determination around now. This would have been consultative and a final determination was planned for September.

7. COVID-19 made that timetable unrealistic. Accordingly, you asked the WICS for advice on how best to proceed. In your letter you asked for their consideration of how best to take account of the economic circumstances likely to prevail at the start and indeed somewhat into the regulatory period, while maintaining progress towards the higher investment needs identified in the review. They responded at the end of April. Their letter is attached at Annex A.

## **WICS Advice and Recommendation**

8. The WICS letter reviews a number of issues and options. Its main points are:

- Scottish Water needs to be able to set its charges for 2021-22 by mid-late February.
- For Scottish Water to be able to set those charges it needs to devise a scheme of charging.
- Scottish Water can only devise a scheme of charging if there is a determination (setting the maximum charge level) covering the period of the scheme. The present determination does not go beyond 2020-2021.
- For Scottish Water to be able to set charges in February, a final determination no later than the end of December is required. This implies a draft determination in October.
- It is impracticable to roll over the present determination or make a determination applying only to eg 2021-22 or 2021-23.

- The Commission recommend that consideration is given to a longer regulatory period – 12 or 15 years , however further discussion with the Commission suggests that alternative governance changes to ensure a long term investment and financing view would be equally acceptable.
- The Commission suggest that the determination could set both a cap (ceiling) and floor on annual charge increases.

## **Consideration**

9. The WICS' identification that it is necessary for a determination to allow charges to be set for 2021-22 is correct. The timetable suggested by the WICS for a determination is sensible and achievable; it may be possible to delay by a couple of weeks and still give Scottish Water time to prepare their charges scheme, but no more. For present purposes, therefore, we should proceed on the basis of the dates proposed by the WICS.

10. In order to facilitate that timetable, Ministers need to finalise the Statement of Objectives and the Principles of Charges before the final determination. These documents were subject to a second consultation which closed just as the lockdown began. You received a submission reporting the consultation recently. In general terms, the documents received the support of those responding. [REDACTED]

11. However this timetable needs to be seen in a wider context. This timing should allow some of the implications of the COVID-19 emergency on Scottish Water, customers and the wider economy to be clearer, but there will still be considerable uncertainties. Scottish Water's own finances are likely to be subject to a number of factors – most significantly the level and pace that revenue from deferred bills can be recovered as the economy restarts and recovers. The capital programme will also have been subject to delay and additional costs. These impacts are being closely monitored in discussion with Scottish Water – we will give Ministers shortly a more detailed initial assessment of their implications.

12. Water charges cannot be viewed in isolation. A range of other charges and taxes, not least Council Tax with which water charges are collected, will need to be set at levels which allow services to continue to be delivered and improved, but which take account of the realities of the economy and the circumstances of households. How the burden of recovery and meeting the residual costs of the pandemic are shared among taxpayers and customers of services raises many questions. It is important therefore that the determination, and its underlying processes, sets a context which allows Scottish Water to respond appropriately.

## **The WICS' Argument for a Longer Period**

13. The WICS recognise the pressure on Ministers and Scottish Water to respond to the circumstances that households (in particular) might face – there have been calls for water charges to be frozen. The WICS are concerned at the implications of any such action for the progress that Scottish Water can make towards the necessary higher levels of investment. The investment needs do not disappear –

indeed they become more pressing. Failure to make this investment will risk declines in performance. If charges are frozen, or kept lower than the level necessary to finance investment, in the early years of the period, then they will be need to be correspondingly higher later in order to recover the lost ground. The WICS are concerned about the acceptability to customers of such future increases – which might be well over 2% in real terms, and also about generational equity. The Commission points to its statutory duty to take account of the needs of future customers. Increasing the burden on them by lightening the burden on today's customers would be inconsistent with that duty.

14. It is from these concerns that the proposal for a longer regulatory period comes. The WICS letter says,

'The Commission sees advantage in allowing for a longer regulatory control period. Such a change could ensure that the commitment of making clear progress towards the strategic challenges of the industry is maintained, yet also allows for increased flexibility being available to the Scottish Government in how it manages Scotland's economic recovery.'

The flexibility referred to here is the prospect of lower charges in the early years of the period. So that this flexibility does not impose undue burdens on future customers the WICS suggest a floor on annual increases, i.e. increases couldn't be lower than a stated figure. That figure would be set by reference to its implications for future charge levels and against the requirement to reach identified levels of investment at certain future points.

15. In proposing a longer regulatory period, the Commission recognise the concern that this would constrain Ministers' ability to develop policy during that period. Ministers might wish to respond to circumstances by changing that framework e.g. by changing the measures for supporting affordability, and this would be difficult. The policy framework applying to charges is set at the outset of the period in the Principles of Charges statement. The Principles of Charges statement has to remain in place for the duration of that period and cannot be amended.

16. The Commission address this concern by suggesting that some flexibility could be planned in to the determination and that their floor and cap proposal provides a basis for doing this – in effect it could provide some headroom for policy changes whose impacts are within the financial envelope of the determination. While this has some elegance, it is difficult to see how it would work in practice. As set out above, Ministers' charging policy, contained in the Principles of Charges statement, is fixed at the outset of the regulatory period. In addition, setting a floor on charge rises is not consistent with the relevant legislation, which is framed only in terms of the determination of maximum charges. The floor proposal is therefore an unconvincing response and we do not think Ministers should endorse it.

17. We accept that the issues the WICS wishes to address in proposing a floor are important. While we do not think Ministers should adopt them, there is no constraint on the WICS examining with Scottish Water the extent to which such a mechanism could be used informally in order to monitor progress. But that is

different from making it part of the determination and different again from Ministers requesting it. The draft letter identifies this possibility.

18. More generally, while we agree with the WICS that there must be a focus on the long term investment requirements, we note the comment of the Customer Forum that there is still some way to go to being confident that customers recognise and share this priority. The Forum continue to advocate increased customer engagement to create the necessary understanding and acceptance of the charge implications. In response Scottish Water have committed to develop a transformation plan, which will set out how they maximise the involvement of customers and communities in decision making, improve how they manage their assets, reach net zero emissions, and harness the full scope of new technology. While a lot of work has gone into assessing what the investment requirements are, and the WICS suggest in Prospects for Prices that there are grounds for thinking the levels being discussed are an underestimate, they will be subject to further refinement and clarification as the years go by. This all suggests that the investment figures that are given absolute status in the WICS' letter should in fact be viewed as a guide at this stage.

### **Way Forward**

19. These considerations make the proposal for a longer regulatory period questionable. We have therefore concluded that it is preferable to continue with the present regulatory period of 6 years, which is already the longest of any UK regulatory framework. It is long enough to allow certainty and continuity of planning. In the manner in which it has further developed over successive periods it allows the investment programme to be continuously developed and extended. There is an inevitable constraint on Ministers' ability to develop policy within the period but it is not unmanageable.

20. The concern about the longer term can be addressed by requesting the WICS to give a firmer view of the prospects for prices beyond the single regulatory period. At present they give an indicative view only. They could be asked to give a stronger view based on stated assumptions and which could be used through the regulatory period to monitor the progress towards the required investment level. Given the importance of the 2040 target, a trajectory to that date should be requested.

### **Flexibility to Address Affordability**

21. The WICS have responded to the expectation that the impacts of COVID-19 mean that it will be difficult to implement charge increases at the levels set out in their Prospects for Prices document next year. Ministers have already faced calls for water charges to be frozen in the light of these impacts on households. While there is no justification for this – the costs of providing the service and the investment needs remain and have to be met somehow - it will be necessary to recognise that many customers will face difficult financial circumstances.

22. This issue needs to be considered in the wider context. Water charges are only one of the pressures customers will face though that does not remove the responsibility to consider affordability very closely. There are many decisions to be

made about how recovery and continuing provision across a wide range of services should be financed. The approach to Council Tax is of particular interest. Research reported by Consumer Advice Scotland suggests that rent and utility bills cause more concern than Council Tax bills (with which water charges are associated.) Unlike water charges, Council Tax charges have risen in real terms in most recent years following a long period of freeze. Given the pressures on council services during COVID-19 it is difficult to see how they can be frozen in coming years. If increased costs facing councils are not met through increased Council Tax, councils will look to Government grant funding or for increased borrowing powers. Ministers have chosen not to grant fund Scottish Water except for very specific projects and, even if funds could be found for this purpose, we consider that this policy should remain. (It is based on the wish to ensure that Scottish Water runs on the tightest commercial lines possible to recover its full costs within its ownership and governance structure. Loans smooth the burden on customers, grants subsidise them.) Decisions on water charges for next year should be taken in the best possible understanding of the choices being made in these, and other, areas.

23. As we have discussed on several occasions in the course of the SRC, the discounts for customers on water charges in Scotland are already at high levels compared with other utilities in the UK. Hardship funds are operated by English water companies but these are discretionary and are significantly less extensive than the discounts available to recipients of Council Tax Reduction which is the trigger for discounts in Scotland. The public ownership of Scottish Water makes this possible, but there are limits on the extent it can go without risking the classification of water charges as a tax rather than a cost reflective service charge. Those discounts are effectively financed by other customers.

24. For as long as the present linkages between water charges and Council Tax continue, the Water Charges Reduction Scheme (WCRS), which gives discounts on water charges to recipients of Council Tax Reduction, will remain the most appropriate means of assisting customers facing difficulty paying. Ministers have already proposed prior to COVID-19 that these discounts should be increased to reflect the additional burden of 2021-27. We consider there is scope for going further as a response to COVID-19. Each 5% increase in the level of support costs around £10m in permanently reduced revenue. Stakeholders most notably Citizens Advice Scotland (CAS) have called for a Scottish Government commitment to the principle of affordable charges for all and greater protection for low income households including a sensitive approach to debt collection. We will propose revised text in the Principles of Charging to respond to that call by including a principle of affordability set in the context of meeting Ministers objectives by Scottish Water. We will ask Scottish Water to work closely with Local Authorities and other stakeholders including CAS to agree suitable debt collection protocols. In more concrete terms increasing the level of support for those on CTR beyond the 30% level already proposed to 35% or 40% goes a long way towards meeting the affordability challenge called out by CAS and does so in a manner that takes income into account given CTR benefit is based on income. Scottish Labour have called for a charge freeze which is of course for the Commission to take into account but is not compatible with meeting even relatively short term objectives and doesn't adequately target support towards those least able to pay. Whilst a freeze is not a viable option

we would expect Scottish Water and the Commission to be sensitive in profiling the prices increases over the period.

## **Other Ways of Affecting Water Charges**

### **Investment**

25. Water charges are driven by the operating and capital expenditure of Scottish Water. The former is already subject to very ambitious efficiency targets imposed by the WICS and there is little scope for anything more. Capital expenditure is determined by the Objectives Ministers set Scottish Water which drive investment requirements. For the most part, the Objectives relate to service standards and are in turn driven by statutory compliance needs. The commitment to net zero emissions by 2040 is also significant. The Objectives have been subject to two rounds of public consultation and have been endorsed by respondents. There is little scope for revising these requirements to reduce the investment requirements faced by Scottish Water. These are not optional investments, they are integral to a life-line national service. Reduction in the overall level of investment required is only deferral, which in turn brings with it risks of declines in performance in areas important to public health and environmental improvement.

### **Lending**

26. The level of lending that Ministers choose to make available to Scottish Water also has an impact on charges. The present assumption is that the Scottish Government will make available up to £1.020bn, or £170m per year. The assumption is for that to decline progressively beyond 2027.

27. Other things being equal, increasing lending would reduce charges - £10m is equivalent to around 0.8% on charges in any one year. However this comes at a cost to future customers as the interest burden grows - an issue to which both the WICS and the Customer Forum have drawn attention. The overall financial situation facing the Scottish Government make it difficult to contemplate additional lending to Scottish Water. The planned amounts are already a significant commitment and the draft letter to the WICS confirms that they should be the basis for further work. Nevertheless this may be an option Ministers wish to consider further in the coming budget setting process. Ministerial bi-laterals are being organised for next month.

28. A similar point could be made about the possibility of grant funding Scottish Water to cover revenue foregone in the first years of the period were charges to be limited. As explained above (para 22), policy in relation to Scottish Water has been set against grant funding. It would be a departure to reverse this policy in response to present circumstances, even if funding could be identified within the Scottish Government budget.

## **Other Stakeholders**

29. In preparing its response to you, the WICS sought the views of other stakeholders. The most significant were those of the Customer Forum. The Forum expressed significant reservations about the implications of a longer regulatory

period. Their main concern was that it would lock in a longer term charge trajectory at a time when it was not clear that customers would accept it. They wanted to develop, and had been discussing with Scottish Water, a more progressive approach than that set out in Prospects for Prices, in which, following an initial step next year a process of customer engagement through a National Engagement Programme, would guide the future charge trajectory within the overall range suggested by the WICS.

## **Setting Charges**

30. Ministers are not responsible for setting charges. It is not for them to say what level of charges should apply next year or in subsequent years. Calls for them to freeze charges are therefore inappropriate. However Ministers' policy framework creates strong expectations and could be framed so as to limit Scottish Water's freedom of action significantly.

31. Charges must be set by Scottish Water with reference to a determination and should not exceed the maximum levels set in that determination. There is no obligation to charge at those maximum levels either in any one year or over the period as a whole. In setting charges Ministers would expect them to take all relevant circumstances into consideration including wider policy objectives and the impacts on customers including through the development of the National engagement Programme with the Customer Forum as referred to above.

32. It is important therefore that Scottish Water is able to do this and the draft letter therefore makes this point.

## **Conclusion**

33. [REDACTED]

34. I would be grateful for your agreement that we should proceed on this basis and that you will reply to the WICS on the basis of the attached draft at Annex B.

35. We would be happy to discuss any points arising, or provide any further information should that be helpful.

[REDACTED]  
**Water Industry**

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**6 July 2020**

