

Customer Forum: Provisional Objectives

Introduction

Since the Customer Forum came into existence in May 2017, we have engaged closely with Scottish Water on the challenges and opportunities for the coming 25 years. We have also considered: Scottish Water's Strategic projections; the initial Decision Papers of the Water Industry Commission (WICS) and draft revised papers; input from the Drinking Water Quality Regulator (DWQR) and from the Scottish Environment Protection Agency (SEPA). We have also gained insight from research commissioned by Scottish Water which the Forum has helped shape, and from research by the Consumer Futures Unit, the wider context of policy trends in the water industry in the UK and statements by Scottish Ministers of the future policy background.

We have been impressed by the ambition shown in some areas by Scottish Water and the desire of its leadership to serve customers well. We also applaud its objectives to improve its community engagement and to enhance Scotland's environment. We believe customers' objectives are likely to support those aims. We also understand our role as being to represent customers of the future as well as those who currently use Scottish Water's services.

Short Overview

We are considering a difficult dilemma. The next seven-year period may see the privatised water sector in England raising charges at a rate significantly below inflation. That would be welcome to domestic customers who have seen a long period of incomes rising below inflation until recently and to businesses who have seen lower demand in the economy. While a 1% rise or fall in average domestic bills amounts to only around £3.60 a year, there are lower income groups to whom that matters, and those with much higher bills on whom the impact would be greater.

Against this background, a case has been put to us that we should maintain growth in Scottish Water's income to allow it to make greater investment each year in maintaining and replacing its assets. Many of those assets are very old, having been constructed during the last century. It has been proposed to us that we need to invest more to protect the infrastructure for future

generations. To achieve that investment, charges would at least need to rise at least to match inflation.

However, we and the Commission believe that Scottish Water is still a fair distance from having the full systems in place to: give it accurate knowledge of the conditions of its assets; categorise their condition appropriately; comprehensively assess and determine the probability of risk; and to make priority decisions between competing demands across the different parts of its business. We are in a constructive dialogue with Scottish Water about how quickly that work can be completed, and on the systems of assurance it would need to have in place.

However, depending on progress we may conclude that it would be premature to plan for greater investment pending completion of the work over the next few years. In those circumstances, we may argue for the benefit of lower real terms charges to accrue to customers.

There are two further areas in which we are in dialogue. The first is on how Scottish Water engages with communities at different stages of its planning processes, particularly with vulnerable customers and the business community. Our ideal outcome would be to see customers take pride in owning Scottish Water. Secondly, we have a strong interest in the way in which Scottish Water meets its contribution to the Scottish Government's Climate Change strategy while 'doing the right thing' in improving our wider environment.

We now explore in more detail what we consider to be the important objectives for customers for the SR21 process. These are provisional, and we want to test them wherever appropriate against further customer research. The objectives are also a response to Scottish Water's draft Strategic Plan. They begin with the important issue of how charges may change and the use to which they will be applied.

Charges

We believe that it is in the interests of customers continuing to receive high levels of service that Scottish Water should have sufficient resource to maintain its current spending power, taking account of growth in its customer base and delivering greater efficiency. We believe customers are most likely to want a price regime that is broadly stable, with no major step

changes or fluctuations. We therefore applaud Scottish Water's ambition to keep customer prices low. Some factors which will reduce Scottish Water's costs mean that customers could have the option of their charges being reduced in real terms as is likely to be the case for customers elsewhere in the UK.

In any discussion on inflation and charges, customers are unlikely to conceive of a more legitimate measure than the 2% target rate for CPI that the Bank of England is given by the UK Government. Customers, both households and many businesses have seen real income fall or, at best, grow slowly over the last decade. A 'CPI-X' approach is therefore likely to appeal to customers since it will encourage efficiency and innovation gains and also takes account of favourable cost factors in Scottish Water's operating environment. Its public ownership means it borrows at very low government rates and pays no dividend.

As mentioned earlier, a case has been made to maintain growth in Scottish Water's income to allow it to make greater investment each year in maintaining and replacing its assets. However, we believe customers would need to have greater confidence than at present that increased charges could be optimally to asset maintenance in the absence of fully developed, rigorous systems. They will want to ensure that expenditure is undertaken against proper understanding of asset condition, methods to rigorously assess needs, quantify risk and make priority-based decisions. Such rigour would be necessary before we could agree to deviate markedly from a real reduction in charges.

We believe that customers also seek greater alignment between Scottish Water's expenditure and actions with wider Scottish Government policy in relation to: the needs of the most vulnerable; delivering carbon reduction and wider environmental policy goals; the development of the amenity of our towns and cities; and community engagement and empowerment. Customers would also benefit from a focus by Scottish Water on wider public policy change that can act to reduce charge pressures on customers, for example as may arise from planning or building standards and other policies in relation to the management of surface water.

Any income generated by price increases should not be seen as 'belonging' to Scottish Water for an entire settlement period. We believe that approval of the release of income should be dependent upon Scottish Water justifying its needs against a rolling three-year horizon. That

may point to there being a longer charge review period of, say twelve years, with three-year break points. That may also give both customers and Scottish Water greater certainty of charges and income respectively.

We believe that the debate around charge levels is not assisted by using an average price which few if any customers actually pay. Customers may appreciate the transparency of being made aware of the actual prices they are asked to pay based on the eight Council Tax Bands. Since water charges are part of the Council Tax Bill households receive, they may also be invisible to the vast majority of customers. This could have an impact on the scrutiny customers might otherwise give them. The Scottish Government currently allows Council taxes to increase by up to 3% annually. This increase may mask the very separate considerations around water charges. Increasing the transparency of Scottish Water's charges is therefore an issue we believe needs to be addressed.

Capital maintenance and asset replacement

A case has been put to us, and we have seen some outline evidence, of a need to increase expenditure on capital maintenance significantly above recent levels in order to replace assets over time. Customers may accept that such investment will be important to ensure that they and future customers continue to benefit from services that are reliable and robust. The WICS is in broad agreement with the analysis that more spending may be needed on capital maintenance. However, uncertainty exists on when such spending may actually be required and at what exact level. The relative priority of this spending to other existing demands for spend is also not yet fully understood.

We do not believe that Scottish Water has yet developed a system that contains sufficiently robust or complete information on asset health; neither does it have correspondingly strong risk analysis and processes for the relative prioritising of spend on asset maintenance. The historic system of spending assessments during past review periods would no longer be sufficient to build and maintain the confidence customers would need that the charge levels they were paying were essential and being spent appropriately to meet the necessary replacement of ageing infrastructure. The systems would appear to need to develop very significantly.

We acknowledge there is work underway to create and improve systems, and we encourage Scottish Water to advance that work as a priority. It should not take too many years to complete if it was given investment and priority. Without that system in place, it will be difficult to convince customers that price increases even to match inflation could be justified. We would also expect independent verification of the fitness for purpose of the new systems. That should also cover current cash availability or the need for the release of cash and become an established part of future systems.

We would also like to see further quantified evidence of the other means (such as growth in the number of customer households and businesses) by which Scottish Water's income will grow and a quantification of the benefits that will accrue from, for example, current low interest rates. The repatriation of expensive PFI schemes may also bring benefits but could equally involve additional investment.

Borrowing has always been a part of investment planning. Customers should not therefore be making up from charges any reduction in new Scottish Government lending that falls below historic levels. Indeed, if higher spending to maintain service levels is necessary, the Scottish Government may play a role in meeting it by increasing borrowing levels. We also believe that customers need to be reassured that borrowing should only be applied to the creation of new, or replacement assets that have a long life.

Transition between review periods

We believe that Scottish Water should be able to fully meet the charge commitments and aspirations entered into for SR15, while exceeding the objectives to be met from the charge levels for the period. We are not yet convinced that a transition between the two charge periods is required to commence in this period. Customers may want surplus cash they have provided to the system to be returned to them in whole or in part, either as individual households or as communities. Customers may support reducing charges for short periods when the cash position may allow it. However, customers may not attach the highest priority to this where that would compromise maintaining current spending power (taking account of growth and efficiency); where any 'relief' to charges is not material to customers; and where it may not cause significant subsequent upward charge pressure.

An alternative would be to allow any surplus to begin a fund to enhance capital asset replacement. However, we would wish to ensure that any funding which customers provide in advance of need is identified and protected. It would also require some independent customer oversight and assurance that is being applied in that way.

We accept that it is potentially in the customers' interests that Scottish Water carries a suitable cash balance for use as a contingency against unexpected and major service failure, or other form of force majeure. The amount of cash in the system at any time should be regularly assessed to determine whether money is being taken from customers at a rate that is higher than necessary to maintain current purchasing power. Where excess cash is being taken, there must be a clear mechanism to consider the 're-basing' of customer charges.

Business Customers

We expect Scottish Water to give greater recognition that, while it has minimal direct contact with business customers, it is trying to understand the priorities of business customers more effectively. We will engage with business customers through their representative bodies to gain their views. However, we believe that the following areas are likely to give rise to concern.

There should be equity in the ambitions to seek to deliver high levels of customer service between domestic and non-domestic customers. Connections and disconnections appear a significant area of concern for businesses. In addition, there are disparities in service and charges which are seen by businesses with sites in both England and Scotland. Perverse incentives appear to apply to businesses that might seek to reduce their surface water discharge, as a result of the rateable value method of charging. Finally, Scottish Water should be taking ownership of complaints which are made to Licensed Providers, but which actually concern areas of service that Scottish Water is responsible for.

We consider that the non-household Customer Experience Measure that is in the early stages of implementation should as a matter of principle form part of the long term measurement of Scottish Water.

Charges - vulnerability and equity.

We are concerned that some customers, particularly those in receipt of full Council Tax benefit, may have difficulty in paying water charges or are unaware that they are falling into debt by failing to pay them. Any possible, future increase in charges would compound financial difficulty for those unable to obtain relief of their charges. We believe that the further development of appropriate relief schemes, funded by the Scottish Government, would be an important consideration in charge increase discussions. We recognise these matters of policy are the subject of discussion between the Consumer Futures Unit and the Scottish Government but also consider them to be relevant to any charge discussions as part of SR21.

We also believe that the balance between what existing customers and developers should pay for growth in the system should be re-examined to shield existing customers from the pressures of development to a greater extent.

Priorities for the use of customer charges

We want to test customers views more fully with Scottish Water, but believe that customers are likely to want their charges spent on seeking to maintain the service levels they currently enjoy at the charge levels they pay; on tackling clear and damaging failures in service (such as internal sewer flooding); on investments that release longer term revenue savings and reduce impacts on the use of the planets' resources; on further improving how they can interface with the company; on moving toward compliance requirements; and then on discretionary improvements to infrastructure informed by robust analysis and risk based priority decision making. Removing lead from the public water supply, which carries a known health risk, is likely to be an important public health measure customers will support.

Communities

We welcome Scottish Water's commitment to strengthen its relationship with local communities and communities of interest. Its commitment to involve communities in decision making is also welcome and we agree that it needs to extend beyond its capital programme. In the coming years we would like to see that engagement stretch beyond

winning the trust of communities to winning their pride in Scottish Water as a publicly owned and managed utility.

Scottish Water appears good at engaging communities where there are planned large scale capital works but there is less evidence of engagement on smaller scale and unpanned works. Its engagement is currently a mix of information provision and, sometimes, discussion of mitigation. There appears, however, a lack of consistency and there is in all probability an appetite in communities for greater engagement.

We believe that there should be a consistent, published engagement process for all planned works covering provision of information, mitigation options and promotion of support to vulnerable groups. A general programme should be targeted at areas experiencing serial problems or close to Scottish Water assets. We would like to see the development of engagement on what happens rather than the current focus on how and when.

We also believe that more support will be required for vulnerable groups as the population ages. The current registration approach appears significantly less well developed than in some other utilities. Scottish Water could learn from and collaborate with other utilities and learn from water companies elsewhere.

We also believe that Scottish Water could be a better partner in relation to wider Scottish Government objectives. This is partly linked to our comments on the environment and climate change below. It is also in relation to wider work with communities around the efficiency of water use, shared approaches to pollution around river and bathing water and community development around Scottish Water's assets. Services in communities not linked to the network are an important aspect of the life of those communities and also raise potential health and service equity questions which require to be addressed.

These are not areas that necessarily require substantial financial investment. They also build on very good practice which exists in Scottish Water in part and in places. We do see a requirement for investment in skills and training to spread and embed that good practice. We appreciate the positive commitment demonstrated by senior management in our discussions. Their leadership (incentivised by appropriate performance measures) and strong commitment by Scottish Water's Board should assist in embedding this change in culture. This

may be territory where new performance measures will have a part to play in delivering the development of practises and incentivising winning the pride of customers.

Environment and Climate Change

Scotland has a world leading Climate Change Plan and targets for carbon reduction. We have also seen recent support for measures to tackle plastic waste and particularly among the young who are Scottish Water's current or future customers. Customers are therefore likely to seek reassurance that Scottish Water is a leader in how it reduces its impacts on the use of the planet's resources, and that it has coherent plans and strategies for action across its business to reduce its impacts. We therefore commend the range of initiatives contained in Scottish Water's draft Strategic Plan and those reported in its annual Sustainability Report. There is a wide range of excellent and often innovative practice in the organisation. In particular, we welcome the approaches to catchment management, reducing leakage, small scale renewable energy and approaches to surface water.

However, such examples are often hard to find in Scottish Water information and in how it portrays itself, and do not appear to reflect a systematic approach across the business. One example is peat restoration where there have been good initiatives by Scottish Water. However, other companies such as Yorkshire Water and United Utilities have taken a much more ambitious approach. Scottish Water could be a champion of the wider water environment but appears reluctant (perhaps because of the fear of cost implications) to take that leadership role by making the environment more central to its priorities. It may also need to build its skills and capacity to see and exploit the opportunities.

The need to adapt to the impact of climate change and the duties that Scottish Water has under Scottish Climate Change legislation mean that reducing carbon emissions will need to be more central to the leadership of the organisation in the coming investment period. It has made steady progress, particularly as one of the largest electricity users in Scotland but could do more such as reporting and reducing the carbon embedded in its infrastructure. We commend the approach taken by Anglian Water in its carbon accounting and reporting. This may be an area where new performance measures could assist reporting and drive improvement.

We would like to see much more focus on using water more efficiently and therefore using less than we do at present. That would produce both environmental benefits and reduced costs. We can do so by growing the support of customers for those aims. There are opportunities to do so through greater partnership with communities and other public bodies to develop an approach based on the principles of a circular economy. That should benefit the interests of customers present and future as well as the environment. Commercial businesses worldwide have seen such benefits, so we would encourage Scottish Water to become a leader in this field. We have not yet engaged fully with Scottish Water on this challenge. However, in common with community engagement, we believe that strong leadership by senior management and the Board would assist bringing about the necessary development we see in the organisation's culture.

Future research

We have ideas for a programme of continuing customer and community research which will assist us in evolving our objectives. We have benefits from the Behavioural Insights programme commissioned by the WICS and will build on that. We are also committed to continue our engagement with other stakeholders in the process which has been very productive.

The research priorities for the next few months will test the appetite of customers and communities for various charging regimes. We also want to engage them on the trade-offs among the candidate priorities for spending priorities for the use of charges. Scottish Water's consultation responses may assist us. We also plan separate engagement with business customers using their representative bodies. Finally, we wish to undertake further work to consider the environmental improvements that Scottish Water could make and test customer views of them. Better community engagement is a given, we believe, and our work will be in assisting Scottish Water in its stated aim of improvement.

We expect to publish an update with firmer views of our priorities by early September 2018.

19 June 2018