

## **Strategic review of charges 2010-14: stakeholder workshops 2009**

### **Discussion paper 8: Capital expenditure efficiency**

This is our final stakeholder workshop before the publication of our Draft Determination on Scottish Water's charges for 2010-14.

At the end of this month we will determine draft charge caps on:

- the amount Scottish Water can charge household customers;
- the 'default tariffs' that suppliers in the newly competitive market must offer business customers; and
- the maximum wholesale price that Scottish Water can charge retail suppliers.

This workshop is the last in a series of eight, designed to discuss the high level areas that will inform the charge setting process. It focuses on our proposed approach to establishing the appropriate level of capital expenditure efficiency to assume for the 2010-14 period. This paper provides some context to the issues we will be discussing at the workshop. We welcome your views and any questions you may have.

### **Background to capital expenditure**

#### **What is capital expenditure?**

Almost half of Scottish Water's annual expenditure is capital expenditure. This comprises investment of around £500 million per annum. Scottish Water incurs capital expenditure in order to:

- maintain its existing assets (its network of pipes, reservoirs and treatment works) – this element of the investment programme is termed 'capital maintenance';
- enhance its assets to deliver customer service and environmental performance improvements – this is termed 'enhancement investment'.

The methods we use to assess the correct level of capital maintenance and enhancement expenditure were discussed at previous workshops. However, it is also important that Scottish Water delivers investment as efficiently as possible. Taking account of investment efficiency ensures that customers pay the lowest reasonable overall cost for the delivery of Ministers' objectives.

Capital efficiency can be achieved in a number of ways, including (but not limited to)

- improved strategic and project planning,

- wiser investment decision making,
- smarter procurement, and
- the use of innovative (cost saving) techniques.

The overall approach we use to review the capital investment programme was explained in detail in our publication 'Strategic Review of Charges 2010-14: Methodology – Volume 4: Approach to capital expenditure'. At this workshop we shall focus on the techniques used to assess capital efficiency.

Our approach aims to identify the extent to which, through measures such as those listed above, capital efficiency can be applied to Scottish Water's investment programme. In its business plan submission, Scottish Water has provided its view of the scope for efficiency in the capital investment programme. Our assessment seeks to confirm whether Scottish Water's view of the scope for capital expenditure efficiency is reasonable and well founded. In our assessment we take into account any special circumstances in Scotland that preclude or limit the scope for capital efficiency.

### **How we assess capital expenditure efficiency**

At the 2009 Strategic Review we will use a similar approach to assessing the scope for capital efficiency that we used in the 2005 Strategic Review. This resembles the approach that has previously been adopted by Ofwat in England and Wales.

For the capital maintenance element we will:

1. carry out a detailed 'bottom up' assessment of Scottish Water's capital maintenance proposals, including taking account of the assessment of the Reporter;
2. use a range of high level 'top down' approaches to establish the level of capital maintenance expenditure which it would be reasonable to expect a water and wastewater company with the characteristics of Scottish Water to require.
3. compare the results of our detailed assessment of Scottish Water's capital maintenance proposals with the high level approaches to establish an appropriate level of capital maintenance expenditure.

The 'top down' approaches will include the use of Ofwat's capital maintenance econometric models. These models compare the relative performance of companies taking into account the characteristics of the networks that they operate.

For the capital enhancement element of the investment programme we will:

1. review Scottish Water's proposals in detail to assess the scope for achieving efficiencies by delivering Ministers' objectives through doing things differently – for example by using more strategic approaches, new technologies or improved working practices;
2. take account of the opportunities for efficiency identified by the independent industry Reporter in his assessment of Scottish Water's proposed investment programme; and
3. apply a proven 'benchmarking' technique, called the 'cost base', to consider further scope for improvements in Scottish Water's capital procurement efficiency.

The 'cost base' technique, developed by Ofwat, uses capital works unit costs to assess the relative efficiency of water companies in procuring and implementing capital projects.

The cost base was first used at the 1994 price review in England and Wales and has been used at each price review both in Scotland and in England and Wales since then. The cost base approach to assessing relative efficiency has been subject to detailed scrutiny by the Monopolies and Mergers Commission and by the Competition Commission. Both found the approach to be fit for purpose.

The cost base is a database of costs, termed 'standard costs', for a wide range of standard projects, or units of work. These standard projects are typical of investment in the water industry. There are standard projects for the water and sewerage services, and for maintenance and quality investment. We can compare Scottish Water's cost base submission with the standard costs submitted by the water companies in England and Wales to assess relative procurement efficiency.

### **Reviewing Scottish Water's cost base submission**

We review Scottish Water's cost base submission in detail to ensure that:

- the standard costs meet our specification and guidance;
- the confidence grades have been correctly applied; and
- Scottish Water has derived its standard cost estimates independently.

To ensure that Scottish Water's cost base submission is directly comparable with those of the companies in England and Wales, we have engaged Jacobs plc to carry out a detailed assessment of the standard costs. Jacobs has carried out similar work for Ofwat for the companies in England and Wales.

The cost base method allows for consideration of any special factors that Scottish Water wishes to bring to our attention in relation to the cost of delivering projects.

### **Considerations for the draft determination**

In reaching our draft conclusions about the appropriate level of capital expenditure to assume, we will need to consider the following:

- the scope for Scottish Water to reduce costs through applying strategic solutions;
- whether the interactions between different elements of the investment programme have been properly taken into account;
- the scope for procurement efficiency resulting from application of the benchmarking ('cost base') approach;
- whether further efficiencies can be achieved through the application of new technologies and improved working practices;
- whether the Ministers' objectives are being met in a manner consistent with Scottish Water's duties on sustainable development; and
- whether we should take account of any special factors.

### **Conclusion**

The role of the Commission is to establish the lowest reasonable overall cost of delivering the objectives set by Ministers for the water industry for the next regulatory period. We achieve this through a careful assessment of Scottish Water's capital investment proposals and the application of tried and tested benchmarking techniques for procurement efficiency to ensure that customers are paying no more than is necessary.

We welcome comments from stakeholders on our approach.