Workshop

Stakeholder workshop 4: Scottish Water's capital expenditure

Strategic Review of Charges 2010-14: Methodology
Stirling, 28 June 2007

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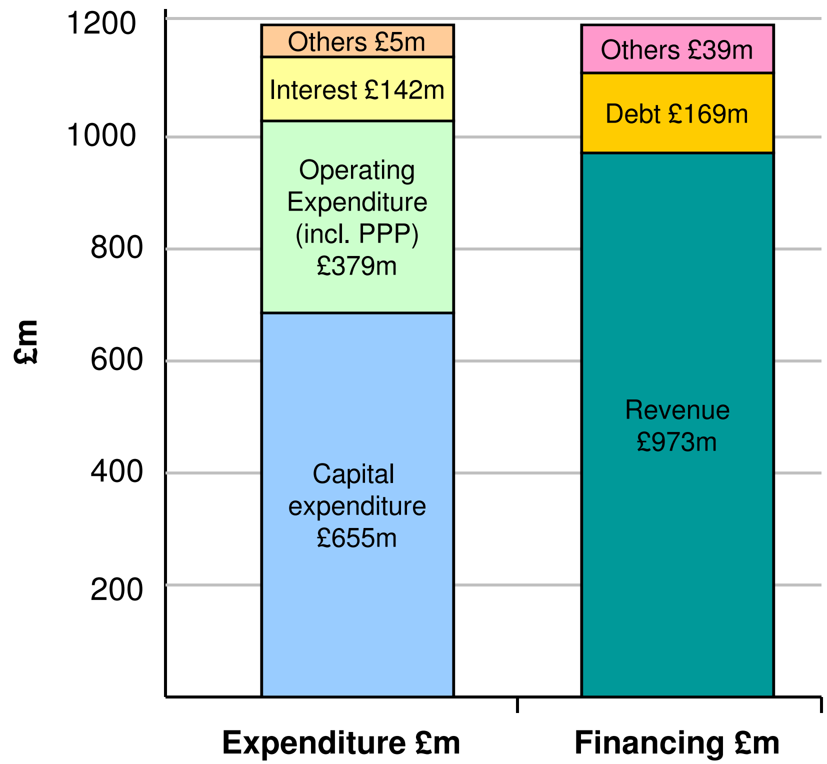
Methodology consultation

- The methodology consultation will be published in 4 volumes during May, June and July.
- For each volume we will hold two workshops for stakeholders.

Volume	Publication date	Workshops
1. Financing Scottish Water	10 May 2007	12 April 2007 26 July 2007
2. Customer revenue and levels of service	31 May 2007	10 May 2007 16 August 2007
3. Operating costs	Today	31 May 2007 30 August 2007
4. Capital expenditure	26 July 2007	28 June 2007 20 September 2007

Capital expenditure (capex) is an important component of Scottish Water's overall expenditure...



In 2005-06, capital expenditure represented c.55% of Scottish Water's overall expenditure.

Scottish Water requires capital expenditure for two reasons:

- to maintain its existing assets; and
- to enhance its assets to deliver service improvements.

In a price review, we need to allow Scottish Water sufficient capital expenditure to deliver Ministers' objectives at the lowest overall reasonable cost.

At the last price review, the high level process we followed was:

1. Ministers set objectives for Scottish Water to achieve by 2010.
2. Scottish Water set out in two draft business plans its proposed investment to achieve these objectives.
3. We asked the Reporter to scrutinise the investment proposals within the business plans and investment proposals. We also used Ofwat and independent consultants to review the programme.
4. Through our analysis we established what would be an efficient level of capital expenditure to deliver Ministers' objectives.

= our allowance for capital expenditure.

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For the 2010-14 price review, some progress has already been made...

- We already have an indication of what Ministers' objectives for 2010-14 will be through the Quality and Standards 3 process which covers 2006-14.

- In establishing the timeline for the 2010-14 review, we have allowed more time for Scottish Water to prepare its investment plans and for our scrutiny of their proposals.

The timeline for the review in more detail

Who	What	When
WICS	Issue guidance to Scottish Water on its first draft business plan	20 December 2007
Ministers	Publish outcome of principles of charging consultation and indicate future investment priorities	1 April 2008
Scottish Water	Submits its first draft business plan	30 May 2008
WICS	Provide feedback on Scottish Water's first draft business plan	31 July 2008
Ministers	Issue guidance on the principles of charging and objectives	30 September 2008
WICS	Issue guidance to Scottish Water on its second draft business plan	15 October 2008
Scottish Water	Submits its second draft business plan	13 March 2009
WICS	Publish the draft determination of charge caps	30 June 2009
Ministers	Issue Directions on objectives and principles of charging	23 September 2009
WICS	Publish final determination of charge caps	30 November 2009

Volume 4 of our methodology consultation will consider the following high-level issues:

- Should our proposed overall approach continue to focus on scrutinising Scottish Water's business plans to ensure that they represent value for money; and if so

- What form should this scrutiny take?

The size of the investment programme that Scottish Water can deliver efficiently will be an important initial consideration

Ministers have already provided initial indications of what their investment priorities will be, but before these are finalised, should we consider the size of the investment programme that can be delivered efficiently?

Scottish Water is already being tasked to deliver the largest water and sewerage investment programme per property in the UK.

- Is there a limit on the level of investment that can be delivered efficiently?

- How much available capacity is there in the Scottish construction industry?

- How much disruption can be borne by local communities as a result of investment?

In order to maintain its existing assets, Scottish Water will require an allowance for capital maintenance.

Capital maintenance expenditure is typically around 40% of total capital expenditure. In England and Wales, Ofwat uses a 4-stage approach to capital maintenance planning. The first stage examines historic information on spending on assets.

- Is there sufficient information to implement this approach in Scotland? If not, what alternatives should we consider?

We propose to ask Scottish Water to provide as much detailed information as possible on their capital maintenance proposals, and use econometric models to determine an appropriate allowance.

- Are there other approaches we could consider?

We will also need to consider the scope for efficiency

Greater capital efficiency can be achieved in a number of ways including:

- improved strategic and project planning
- better procurement; and
- innovation.

Ofwat use a 'cost base' approach to establish the scope for procurement efficiency. We used this approach in the 2006-10 review.

- Is it appropriate to use the cost base approach this time? Should we consider other ways of establishing efficiency?

Are there ways in which we can help to smooth fluctuations in the investment programme over the four year control period?

During any regulatory control period, investment tends to dip in the early years and peak towards the end.

- Are these fluctuations an issue? And for whom?

- Would allowing Scottish Water to make an 'early start' to its investment programme help to mitigate this issue?

- Is an early start programme consistent with maintaining a focus on the current large investment programme?

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Defining and financing Scottish Water's investment programme is just the beginning of the process.

Over the 4 year regulatory control period, Scottish Water will be required to deliver Ministers' objectives.

- How can we monitor if required outcomes are delivered?

The Output Monitoring Group (OMG) was established at the last review to monitor the delivery of outputs during 2006-10.

- Can the role of the OMG be enhanced?

- Are there ways at the outset of the period that we can help the OMG do its work? For instance, by better defining how the investment programme translates into outcomes.

Any other issues?