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Investment planning and prioritisation

Introduction

This is the third in a series of 2018 Decision Papers that the Water Industry Commission will publish for the Strategic Review of Charges 2021-27. The Commission published thirteen Initial Decision Papers during 2017. The Commission will issue a series of further Decision Papers throughout 2018. These papers will update customers and stakeholders on the Commission's latest views and decisions for the Strategic Review of Charges 2021-27.

The 2018 Decision Papers provide the Commission's views on:

- Strategic issues facing the industry that will impact levels of service beyond the next regulatory control period;
- The prospects for customers' charges during the next regulatory control period;
- Issues that directly and materially impact the charges that customers will pay in the next regulatory control period; and
- The potential for Scottish Water to engage even more effectively with its customers.

The clarity of the governance framework for the water industry in Scotland is a significant strength. The role of the Scottish Government as policy maker, owner and banker is well defined and recognised. The objectives and principles of charging set the boundaries for the Strategic Review of Charges. As such, discussion about approaches to asset replacement, 'planning and prioritisation' of investment and compliance with European Union Directives takes place within the policy for the industry set out by the Scottish Ministers.

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review, taking account of all the evidence available to it in coming to the views set out in these Decision Papers. The final section of this paper sets out the framework for the key performance indicators that we will use to oversee the delivery of the changes to the regulatory framework.

In line with the Cooperation Agreement signed with Scottish Water and Citizens Advice Scotland, the Commission would be minded to adopt a Strategic Plan that is consistent with the Commission's Final Decision Papers and agreed with the Customer Forum as its Draft Determination.

This third 2018 Decision Paper sets out the Commission's thoughts on the investment planning and prioritisation process. Investment planning and prioritisation will play an important role in ensuring that stakeholders can provide input to Scottish Water's investment planning within the objectives established by the Scottish Ministers.

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The Commission's expectations

In its methodology for the Strategic Review of Charges 2021-27, the Commission set out its expectations for future proofing the water industry for customers. Scottish Water should:

1. Develop a clear strategy, maximise the opportunities available to it and provide clear evidence for its approach. Stakeholders will expect to be able to scrutinise the evidence provided.
2. Adopt behaviours that build trust and make progress in instilling pride among its customers and within the communities that it serves.
3. Ensure its asset management allows it to evidence the resources that it will need to improve its performance. Develop the asset information, which will underpin effective, efficient and timely replacement of its assets.
4. Improve its efficiency and, where appropriate, take advantage of innovation to ensure that prices are kept as low as is consistent with a sustainable industry for future generations.
5. Work collaboratively and constructively with regulators and other stakeholders to identify and implement the most effective and efficient solutions.
6. Improve the transparency and frequency of its reporting on performance.

The Commission considers that there are three key building blocks of this Strategic Review of Charges:

- *Evidencing the asset replacement challenge and developing an appropriate, efficient and effective response.* The Commission is working closely with Scottish Water and other stakeholders to establish an approach to long term asset replacement. It expects Scottish Water to develop a common understanding amongst its stakeholders of the resources that it will require in order than an appropriate transition to a sustainable level of annual investment can be put in place. Such a transition should be fair to both current and future generations. The Commission will set out its latest thinking on this issue in 2018 Decision Paper 5.
- *The introduction of a rigorous investment planning and prioritisation process:* Scottish Water will set out succinct, yet comprehensive investment appraisals that will allow stakeholders to provide an informed view on Scottish Water's proposals. Such appraisals should cover the impacts on, and views of, customers and communities. The Commission sets out its initial views in 2018 Decision Paper 3.
- *The process for evidencing financial, service level and water and environmental compliance in the coming regulatory period and beyond.* The Commission will set out its initial thinking on monitoring performance in 2018 Decision Paper 6.

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Overview

The Commission explained that Scottish Water should likely be investing more in the next regulatory period in Initial Decision Paper 4. However, the Commission expressed some doubt as to whether Scottish Water could deliver any such additional investment effectively and efficiently. In particular, the Commission had a concern that Scottish Water had further to go to build the trust and confidence of stakeholders, customers and communities that it would deliver value for money.

The trust and confidence of stakeholders, customers and communities will require Scottish Water to develop a more comprehensive understanding of the condition and risk profile of its assets. Such an understanding will underpin its investment appraisals. The Commission considers an investment planning and prioritisation process as an essential step to building trust among stakeholders and ensuring customers get value for money.

Stakeholders have expressed support for an investment planning and prioritisation process. They want an opportunity to input to Scottish Water's decisions on investment priorities. Stakeholders consider this to be particularly important given the asset replacement challenge. Through our joint working fora, stakeholders have agreed a set of principles that should underpin the investment planning and prioritisation process. These are:

- Scottish Ministers will continue to set policy and objectives for the industry;
- Regulators' statutory responsibilities to customers, the public and the environment are unaltered;
- Scottish Water will make decisions on planning and prioritisation and retain responsibility for outcomes;
- The Customer Forum will seek to agree the Strategic Plan with Scottish Water, including the process for customer involvement in the planning and prioritisation process; and
- The Output Monitoring Group will continue to monitor delivery of committed projects.

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Stakeholders have also discussed the key elements of the investment planning and prioritisation process. These include:

- Scottish Water should involve stakeholders in developing an extensive list of potential requirements and aspirations based on Scottish Ministers' objectives for the industry;
- A joint stakeholder group would comment on Scottish Water's assessment of the potential requirements and aspirations in terms of both urgency and importance and which potential requirements and aspirations should be taken forward for appraisal;
- Scottish Water would produce investment appraisals for the identified priority requirements and aspirations;
- The appraisals would be appropriately succinct but sufficient to enable meaningful discussion within the joint stakeholder group;
- Scottish Water would take account of the input of the stakeholder group in deciding which projects to progress to the revised 'Technical Expression'¹. This would include Scottish Water setting out timescales for delivery of the output.

This investment planning and prioritisation process will allow stakeholders to understand and to input to Scottish Water's investment choices. The appraisals will explain benefits and costs of different approaches and outline opportunities for innovation. Scottish Water is responsible for deciding (within the framework of the Objectives of the Scottish Ministers) what it advances to delivery and includes in its revised 'Technical Expression'. Scottish Water should therefore be able to maintain very substantial visibility over its capital programme. The increased scrutiny of the investment appraisals should increase efficiency in the definition of approaches to issues and in delivery. The supply chain will still have a high level of visibility and should avoid some of the uncertainties that were inherent in the previous 'Technical Expression'.

Scottish Water has taken the lead role in defining the investment planning and prioritisation process in more detail. This will include a template for the investment appraisals. Scottish Water will develop and agree a workplan with its stakeholders. This plan will be published. The plan will set out how the industry will achieve a smooth transition from the current to the next regulatory control period.

We have captured our current views in the following bullet points.

¹ The 'Technical Expression' is the agreed list of committed projects and outputs.

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The Commission's thinking as it began the Strategic Review of Charges 2021-27...

- The Commission wanted to ensure that customer bills remain broadly stable. However, it also identified that Scottish Water was likely to have to invest more in future regulatory control periods, particularly in replacing its assets.
- Based on the available evidence, the Commission was concerned that Scottish Water may not yet be ready to deliver significantly higher levels of capital expenditure efficiently and effectively.
- The Commission could cut customer bills modestly in real terms in the next regulatory period even if it allowed for slightly higher levels of investment and the Scottish Government continued to make borrowing available.
- However, the Commission recognises that even a modest cut may have serious implications for future regulatory control periods (if current expectations of levels of required investment prove to be accurate). The Commission could put itself in a position where it had no choice but to increase charges significantly faster than the rate of inflation.
- The Commission sees the successful introduction of an investment planning and prioritisation process as being essential to protecting customers' money and the efficient and effective use of Government's borrowing.

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The Commission's joint working with stakeholders has allowed its thinking to advance both more quickly and more productively...

- The Commission is encouraged to have made progress in developing a common understanding of the critical inputs to the Strategic Review of Charges.
- At a strategic level, the Commission considers that Scottish Water has more to do:
 - To evidence its understanding of the condition of its assets;
 - To demonstrate robust appraisal of the needs and aspirations that it has to satisfy;
 - To enrich dialogue with customers and communities and augment social and natural capital; and
 - To build the trust of stakeholders across all of these areas.
- The Commission intends to strengthen the regulatory framework to ensure that customers' money can only be spent when Scottish Water can provide clear evidence of a need to spend and a capacity to commit resources effectively.
- In so doing, Scottish Water should be able to evidence that it is meeting the expectations of stakeholders, customers and communities.
- In line with Ministers' Draft Objectives, the proposed investment planning and prioritisation process will support a move to setting a longer term price profile and should create a more sustainable industry where statutory requirements and investment aspirations can be met timeously and social and natural capital can be maximised.
- The proposed investment planning and prioritisation process will give Scottish Water the space to focus on meeting the expectations of customers and communities.
- It should also build the confidence of Ministers and other stakeholders that the industry is responding effectively to the longer term challenges that it faces.

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The Commission is very pleased that Scottish Water and its stakeholders have engaged so regularly...

- The Commission is encouraged by stakeholders' engagement in defining the principles of investment planning and prioritisation. All agree that an investment planning and prioritisation process will change behaviours and incentives and bring new benefits.
- There is a consensus across all stakeholders that customer and community views will add value to such a process. Scottish Water's engagement with customers and communities should be both earlier and more comprehensive.
- For example, the proposed new Drinking Water Directive will require much greater engagement and sharing of information with customers and communities.
- The Quality Regulators are clear that they can input effectively to the planning and prioritisation process. They are also clear that such input will not compromise their statutory duties to enforce standards.
- Equally, however, they are clear that they want full visibility of all types of investment expenditure and reassurance that legal standards will be met.
- Robust investment appraisal should demonstrate the value of significant investment in the water industry to customers and wider Scottish society.
- The current regulatory framework has led to an over-emphasis on achieving milestones potentially at the expense of efficiency and the effectiveness with which needs are met.
- All stakeholders agree that the proposed investment planning and prioritisation process could increase the flexibility, efficiency and effectiveness of investment in the water industry in Scotland. Customers, communities and the supply chain would all appear to benefit in different ways:
 - Customers and communities from better responsiveness to needs;
 - the supply chain through longer-term visibility; and
 - all three from commitment to long-term strategic projects.

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As the Commission is at an early stage of the Strategic Review of Charges, there are a number of outstanding issues...

- When will Scottish Water develop a comprehensive understanding of when and how it will replace its existing assets?
- To what extent do stakeholders have confidence in Scottish Water's current actions and future plans for asset management?
- Can Scottish Water reassure all stakeholders as to the operation of the investment planning and prioritisation process? Will it involve customers and communities sufficiently?
- To what extent will Scottish Water's investment appraisals meet the needs of Government; WICS; The Quality Regulators; CAS and the Customer Forum; and other stakeholders?
- Will Scottish Water's plans and approach deliver the long term sustainable industry that Ministers expect?
- Would independent review of Scottish Water's plans and approaches help build the confidence of the Scottish Government, the Quality Regulators, customers and communities?
- How will the insights of Behavioural psychology and innovative approaches, such as 'Apptivism'², be incorporated in Scottish Water's strategy?
- How significant an opportunity could community-oriented service level 'health checks' provide?

² 'Apptivism' is an online citizen research facility which is being used by the water industry stakeholders in Scotland to gather customer views through the 'Chat Scotland' messenger portal.

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There is much to do. The principal next steps in the Strategic Review of Charges process include...

- Scottish Water will need to build on the success of stakeholder discussions to ensure it can resolve any issues arising and, most importantly, build confidence in its direction of travel.
- Such discussions should be informed by extending outreach to communities, behavioural Insights and the targeted use of powerful modern research tools such as 'Apptivism'.
- Scottish Water will have to give further thought to how it maximises natural and social capital.
- For long-term price setting to be successful, all stakeholders will need to continue to embed the principles of Ethical Based Regulation in the water industry in Scotland.
- The Commission is pleased that stakeholders have now signed off the principles of the investment planning and prioritisation process. Scottish Water has now agreed to take this forward.
- Scottish Water will now develop a work plan for designing the process. Stakeholders have agreed to participate in a joint working group to input to the process.
- In designing the investment planning and prioritisation process, Scottish Water will have to consider:
 - The priorities of its stakeholders;
 - How stakeholders will gain and maintain confidence in the governance of the process;
 - How needs and aspirations progress through the pipeline; and
 - The detail of its approach to investment appraisal.
- Stakeholders will be particularly interested in ensuring that Scottish Water is appropriately funded to meet its long-term maintenance needs and ensure intergenerational equity.
- This enhanced approach to the economic regulation of the industry should help build the confidence of Ministers that, as a minimum, their objectives will be met and ensure that the industry is responding effectively to its longer term challenges.

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Timetable for 2018 Decision Papers

The Commission sets out its current timetable for the publication of its 2018 Decision Papers in the following table.

2018 Decision Paper	Topic	Publication date
1	Scottish Water's Strategic Projections: A summary of our current thinking	25 July 2018
2	Assumptions on macroeconomic inputs and customer base growth	25 July 2018
3	Investment planning and prioritisation	25 July 2018
4	Meeting long-term investment needs	26 September 2018
5	Capital Maintenance	26 September 2018
6	Performance monitoring	21 November 2018
7	Financial tramlines	21 November 2018
8	Prospects for prices	21 November 2018

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Regulatory framework: Key Performance Indicators

Ethical Based Regulation requires a defined framework in which a regulated company is expected to operate. It offers clear benefits to a regulated company that meets and exceeds the expectations that underpin the framework. It envisions a more collaborative approach – not necessarily always working jointly on issues – that will take more informed and better evidenced decisions and build the trust and confidence of customers and communities. The Commission set out its expectations of such a ‘paradigm shift’ in its methodology for the current Strategic Review of Charges.

The Commission’s framework for economic regulation seeks to ensure improved and sustainable outcomes for customers and communities. If it is working effectively, Scottish Water should be demonstrably making progress towards such improved outcomes.

The Commission is developing key performance indicators for monitoring, and reporting on, the revised framework for economic regulation. These indicators should apply during the current Strategic Review of Charges and in future regulatory control periods. They test whether the framework for economic regulation³ is meeting the expectations of stakeholders and that we are making appropriate progress. Stakeholders are well positioned to gauge whether the framework is successful in allowing the industry to meet its longer-term challenges.

The performance indicators include a set of quantitative measures that should be linked to key delivery milestones within Scottish Water’s work plans for the Strategic Review Process and for the 2021-27 regulatory control period. There are also a range of qualitative assessments that all stakeholders should address regularly. The aim of these regular assessments is to ensure that there is a useful common understanding of whether the regulatory framework is working for customers and communities. Doubtless, such assessments may also identify areas for improvement.

The Commission proposes to carry out an independent qualitative survey of all stakeholders throughout the period of the implementation of the new regulatory framework. The Commission will work jointly with OECD and stakeholders to define how best to take this process forward. After the Strategic Review of Charges, the Commission would seek to agree with the stakeholders how this regular qualitative survey is maintained and, when appropriate, enhanced. The views of customers and communities will be of particular importance in this regard.

The framework of the key performance indicators set out in the chart on page 12 reflects six key building blocks outlined in the methodology. They are centered around, and dependent upon, Scottish Water taking full ownership of its strategy.

The Commission considers that the answers to these questions will provide a useful and continuing perspective on the performance of the economic regulatory framework. It looks forward to discussing with stakeholders the most appropriate way to measure the quantitative assessments included.

³ The Commission’s expectations are set out in its methodology document, ‘*Innovation and Collaboration*’.

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The Commission also recognises that the qualitative tests may be supported by some additional (and more detailed) questions. For example, it may be useful to track how stakeholders' expectations of the regulatory framework are changing at the same time as stakeholders' satisfaction with the outcomes of this framework are assessed. The Commission again looks forward to working with stakeholders to define the detail that underpins the high level qualitative assessments included in the chart.

Chart 1 – Framework for key performance indicators

