

## Methodology Information Paper 24: Capital efficiency

### Introduction

This information paper explains our thinking on the different types of capital efficiency that large, asset-intensive companies such as Scottish Water can achieve.

### Capital efficiency

Capital efficiency involves delivering the same outputs to customers at a lower cost. There are a number of ways in which a company can improve its capital efficiency:

- strategic asset management,
- programme planning or investment appraisal,
- procurement, and
- innovation’.

#### *Strategic asset management: ‘saving by not doing’*

Strategic asset management savings can be achieved by simply not spending the money that was allocated. It is essential to bear in mind that not spending would only be considered to be an efficiency if this were done without compromising output and performance measures. An example would be replacing pumps every five as opposed to every three years.

#### *Programme planning or investment appraisal: ‘doing it better’*

Improved programme planning could reduce the number of times an asset is visited in order to achieve the required outcomes. If contractors are on site, it could, for example, be more efficient to accelerate some planned capital maintenance.

#### *Procurement: ‘buying it smarter’*

This is perhaps the most obvious area where there is scope for efficiency. We can assess the scope for procurement efficiency by comparing the prices paid by a full range of companies and authorities for standardised capital projects.

In price setting, regulators have tended to focus on measuring procurement efficiency as it is readily measurable and potentially provides the largest scope for savings. We set out the cost base method for assessing procurement efficiency in Information Paper 25 ‘The cost base approach’.

*Innovation: 'doing it the new way'*

There is also likely to be some scope for efficiency to be achieved through innovation. We can compare current practice with new lower-cost techniques that are available.

**How capital investment efficiency is assessed**

We assess procurement efficiencies using Ofwat's cost base approach. As noted above, procurement efficiencies are often likely to form the largest part of potential cost savings<sup>1</sup>.

The cost base approach does not assess the impact that strategic asset management, programme planning or innovation can have on reducing the costs of delivering capital investment outputs.

Information Paper 19, 'Reviewing the baseline programme', set out how we propose to carry out a detailed scope challenge of Scottish Water's capital investment proposals for 2010-14. This review will identify the potential for improved efficiency from strategic asset management, improved project planning and technical innovation.

Our incentive based approach to the regulation of Scottish Water will encourage management to maximise its capital efficiency. Our approach allows a determined management to outperform the regulatory contract and deliver the ministerial objectives for less than we allowed for. It is important to strike a balance between the price paid by customers now and ensuring that management have a reasonable incentive to improve their performance. At the next Strategic Review of Charges, we can pass any additional savings to customers in the form of lower prices.

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<sup>1</sup> In 2001, the last time that each procurement area was discretely measured, Procurement inefficiency was around 29.5%. This compares to around 5.5% for innovation and 12.7% for the sum of strategic asset management and programme planning.