

Maintaining base service

Introduction

This note summarises issues arising from Scottish Water's Service Improvement Report on capital maintenance. We will comment in more detail on Scottish Water's final proposals for capital maintenance which will be set out in its Strategic Business Plan (due to be published in October 2013).

Summary of the information provided in the report

Scottish Water's report explains the factors that define 'base service'; this includes levels of interruptions to supply, water quality issues, flooding incidents and pollution. The report indicates that, according to its research, customers do not want to see a reduction in any area of base service. Within the category of base service, drinking water quality was considered to be the highest priority.

The report provides information on capital maintenance investment levels since 2002, stating that actual investment has been around £240 million to £250 million a year. Scottish Water argues, however, that when efficiency improvements are taken into account there has been an underlying increase in activity over the past 10 years. This is attributed to the impact of higher standards of service (both in terms of drinking water quality and environmental performance) over the period and the addition of a large amount of new plant and equipment to meet these higher standards in recent years.

The report indicates that, in the next regulatory control period, significant increases in capital maintenance will be required in order to maintain the improvements in service, drinking water quality and environmental performance that have been delivered during the current (2010-15) period. Scottish Water further states that, while efficiency improvements have largely offset the cost of the increased investment to date, ongoing improvements in efficiency will only partially off-set further increases in future.

More specifically, the report notes that:

- the higher service levels require a lower risk of asset failure;
- the new above-ground assets that were installed between 1990 and 2005 (some £4 billion of investment) have increased the on-going maintenance requirement;
- many of these new above-ground assets are reaching their first major refurbishment requirement; and
- investment has been required in high technology assets that have shorter operating lives.

Scottish Water proposes that to maintain stable service levels in the next regulatory control period would require investment of around £270 million to £300 million a year. The level of investment during the current regulatory control period is estimated at around £235 million a year. As such the proposed investment represents an increase of around 15-30%.

Scottish Water's assessment is based on asset risk and asset stewardship modeling and on 'bottom up' activity reviews. To validate the output from these asset management models, a simple asset replacement model was used.

Scottish Water's report compares the increases it is forecasting with changes in capital maintenance levels in England and Wales (which have gone up by around 50% over the past ten years).

Issues arising

Scottish Water's claim for an increase in capital maintenance is not surprising. There has been a trend towards the use of telemetry and shorter-life assets more generally. This trend has been particularly marked over the last 15 years.

There is no way of being sure whether the proposed level of capital maintenance is too high, too low or just about right. This is because the expected level of capital maintenance relies on the predicted performance of Scottish Water's assets.

We need also to recognise that while Scottish Water's management should be risk-averse in its stewardship of its assets, there is a risk that customers may be asked to pay more than is reasonable.

So how do we make ourselves comfortable that the increase in capital maintenance is justified and should be being met by current customers?

In our view, the Customer Forum could reasonably:

1. Agree a profile for the expenditure of the allowance for capital maintenance, and require reporting from Scottish Water on the delivery of this allowance.
2. Seek to define clearly the additional improvements in customer service that will be delivered as a result of increased spending on maintenance.
3. Agree targets for the new Asset Health Indicator¹.

We will set out further guidance for the Customer Forum when we receive Scottish Water's draft Business Plan. This will include advice on the overall level of expenditure, the use of innovative approaches adopted by Scottish Water (to reduce costs or to improve performance), the efficiency of the proposed expenditure, and the extent to which it impacts on the prices customers will pay.

Monitoring capital maintenance expenditure

The Customer Forum could require reporting on actual expenditure of capital maintenance and on progress against planned expenditure by using the overall measure of delivery (OMD) tool that is being used in the current regulatory control period. It may seek to ascertain:

- the improvement in efficiency in the delivery of capital maintenance that Scottish Water has achieved over the past several years; and
- the improved asset performance that has resulted from investment in new assets and in the reduced levels of leakage that have been achieved.

These factors could reasonably be assumed to have reduced overall expenditure on capital maintenance. As such they should be quantified in order to assess whether or not the cost of enhanced customer service, reductions in operational risk and improvements in asset health are reasonable.

¹ We will provide the Customer Forum with a note on the Asset Health Indicator once its operation has been more fully developed.

Monitoring improvements in customer service

Higher expenditure should reduce risk, improve customer service and result in asset condition being better than it would otherwise have been. In addition to capturing the customer service improvements in a revised OPA, the Customer Forum may consider it appropriate to define how operational risks that could lead to service interruptions will have been reduced. These too could potentially be captured in a revised OPA.

It is likely to be important that Scottish Water defines clearly the service level improvements that will result from the proposed level of capital maintenance. There should not, of course, be any overlap with discretionary improvements to the level of customer service that are agreed with the Customer Forum.

Monitoring underlying asset health

Current customers benefit when Scottish Water borrows to cover some of the initial cost of service or environmental improvements. This is because the bill for these long-lived assets is being shared with future customers, who will also benefit. However, this increases the responsibility of current customers to ensure that the condition and performance of assets does not deteriorate under their stewardship. If they were to deteriorate, this would either increase the costs that have to be borne by future generations of customers or would reduce the level of service available to them.

Scottish Water is currently developing an Asset Health Indicator. This will use the best information available to Scottish Water on current performance and the condition of the assets and will model potential future condition and performance profiles under different scenarios. The Customer Forum may want to agree targets for the Asset Health Indicator with Scottish Water based on its agreement of the allowance for capital maintenance.

Agreeing the final package

We would suggest that the Customer Forum seeks to specify clearly the levels of expenditure, risk reduction, customer service enhancement and improvements to asset health that have been agreed with Scottish Water. This should encompass both the response to the increase in expenditure on capital maintenance, and any agreed discretionary expenditure on improving customer service. This information should then form part of the Customer Forum's agreement with Scottish Water.

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