

## Efficient use of capital investment expenditure

**This note outlines our initial expectations of how Scottish Water will maximise the efficiency of its capital investment expenditure over the 2015-20 regulatory period.**

### Key messages

Scottish Water's current level of capital investment looks set to remain broadly constant for the foreseeable future, assuming that improvements in drinking water quality, environmental performance and services to customers continue at the current pace.

We endorse the Scottish Government's view that a level of capital investment of between £450 million and £500 million a year is likely to be most efficient.

There is strong evidence that Scottish Water has improved both its cost efficiency and delivery of capital investment over previous regulatory periods. Equally, we consider that Scottish Water should be able to make further efficiencies through more innovative solutions, a more strategic approach, and smarter procurement and delivery. These further efficiencies will allow Scottish Water to deliver both increased value for money for customers and additional water quality, environmental and customer service benefits.

### Introduction

Capital investment expenditure is the amount a company spends on maintaining and improving its assets. Capital investment expenditure is generally for "one-off" projects. It is therefore different from expenditure on ongoing, day to day activities (the subject of Note 1) or costs such as financing costs and taxes on profit.

We recognise two categories of capital investment expenditure: capital maintenance and capital enhancement.

#### Capital maintenance

This is expenditure to maintain or extend the operating life of an asset. It generally involves making significant repairs, or replacing part, or all, of the asset. For example, it would include expenditure to renew water mains and sewers or replace worn out pumping equipment. Without such expenditure, the assets would deteriorate, their performance would decline, and they would ultimately fail. This would be reflected in lower levels of service provided to customers. To protect against this, the Scottish Government sets targets for service performance that Scottish Water must maintain.

Considerable knowledge and expertise is required to assess the appropriate level of capital maintenance expenditure, and to target it towards the right assets at the right time.

#### Capital enhancement

This is expenditure either to extend existing assets (so they can serve new customers) or to provide new assets that provide an improvement in the service received, or both. Most of this expenditure is directed towards delivering public health, environmental and economic growth objectives set by the Scottish Government. It includes, for example, expenditure on new treatment works to improve water quality or environmental performance, or extensions to the water and wastewater networks to serve new customers.

Without such expenditure, any improvement to service would have to be obtained, where possible, through an operational solution (see Note 4), and in most situations major extensions of the water and

sewerage service to accommodate new customers would not be possible. For a given level of capital investment expenditure, the challenge for Scottish Water is to ensure that it achieves the maximum possible benefit for customers in performance.

### The size of Scottish Water's capital investment programme

In 2007 we commissioned research<sup>1</sup> into the size of investment programme that could be delivered efficiently in Scotland, by examining evidence from England and Wales. We commissioned the research because Scottish Water's investment programme at the time was one of the largest ever delivered in the UK water industry, and there were signs that it was proving too large to manage.

The Scottish Government recently acknowledged the findings of this research when it restated its intention<sup>2</sup> that Scottish Water's investment programme for the next regulatory period, 2015-20, should be between £450 million and £500 million a year. We fully endorse this range. For reference, the current investment programme for 2010-15 is also likely to be within this range.

Getting the size of programme right is critical to delivering a continuing reliable service, and to making improvements, in a way that is sustainable and does not put undue pressure on customers' bills. At present, the charges customers pay are sufficient to cover an annual investment programme of the desired size (providing sufficient borrowing is available to Scottish Water (see Note 4)).

While the evidence suggests that a programme size of between £450 million and £500 million is likely to be the most efficient, this certainly does not guarantee that a programme of this size will be delivered efficiently. This would require concerted management action by Scottish Water to ensure that value for money is achieved in delivering such a significant level of investment each year.

### What we mean by efficient capital expenditure

Like all other water and sewerage companies, Scottish Water is a capital-intensive business. The size of its investment programme is determined largely by Ministers' objectives and by the need to maintain its assets and the services these provide. However, there are a number of steps in planning and delivering investment where there are significant opportunities to improve the value for money from this investment. We provide some examples of these opportunities below:

#### **Strategic planning**

Strategic planning helps the company to focus resources to best long-term advantage. This will mean that it invests in assets that fit well within the continuing long-term demands (political, legal, social, economic and customer driven) placed on the water industry.

#### **Information**

The company requires accurate and complete information about its assets. This includes the volumes of water and waste water that it processes and the nature and demand patterns of the customers it serves. This should enable an accurate assessment of the need for investment.

#### **Appraising alternatives**

The company must identify and appraise the full range of possible alternative ways to provide either the improvement that is needed or the maintenance that is identified as necessary, based on its strategic plan and good information.

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<sup>1</sup> LeCG report 'Factors to be considered when determining the appropriate size of the next capital programme for Scottish Water', 2007, <http://www.watercommission.co.uk/UserFiles/Documents/SW%20Capital%20Programme%20-%20Summary%20Final.pdf>

<sup>2</sup> Scottish Government's engagement paper 'Investing in and paying for your water services from 2015', June 2012.

### **Project scoping and design**

The project that is selected on the basis of a full and wide-ranging appraisal must be scoped then designed in a cost-effective way. For example the designed capacity of a new asset may be too small or too large, or the process may exceed or fall short of the required improvement. It may also be that the design work itself is more expensive than is necessary.

### **Project procurement**

Once properly designed, the project needs to be procured efficiently. This means that the company has achieved a good price for its construction and is not accepting an undue level of risk that could be borne by the contractor. This may happen, for example, where the company has not negotiated as effectively as it could with suppliers, or has not considered a sufficiently wide selection of suppliers.

### **Project delivery planning**

The project delivery must be planned effectively. For example, foreseeable difficulties such as the need for planning permission, adverse weather or interaction with other projects must be properly factored in.

### **Project management**

A well planned project still needs to be well managed. This includes, for example, ensuring the quality of workmanship and materials, as well as minimising opportunities for successful claims for extra costs by contractors.

In theory, the overall efficiency of capital investment is, quite literally, the product of how well the seven elements listed above are carried out. Purely as an illustration, just a 5% excess cost for each of these elements would result in overall investment costing over 40% more than it should<sup>3</sup>.

## **Assessing Scottish Water's performance**

A detailed assessment of Scottish Water's performance in the areas outlined above would require very intrusive regulatory investigation. We undertook such work in our 2005 price review, when we concluded that Scottish Water's projected costs were 56% higher than they needed to be. Our work at that time did not cover all of the areas listed above, but focused mainly on scoping and procurement.

Scottish Water accepted the reduced costs and subsequently delivered its investment programme for the regulatory period 2006-10 within the cost limit we had set. In doing so, it made a major step towards capital investment efficiency.

In our 2009 price review we focused on procurement efficiency. This is, arguably, the least difficult area to assess because standard water industry benchmarking tools are available. It is an area where we have been able to track progress against companies in England and Wales in a like-for-like way for several years.

In 2009 we found that Scottish Water's costs were higher than the level achieved by upper quartile companies in England and Wales. To address this difference, we set prices on the basis that Scottish Water would reduce its projected investment costs by 14.5% by 2015, while still delivering the improvements that had been agreed. Scottish Water appears to be making good progress towards achieving this, in that it is reporting that it has delivered improvements ahead of schedule, and that its costs are below those forecast. This suggests that Scottish Water is continuing to make progress in some or all of the areas discussed above.

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<sup>3</sup> This illustrative example is calculated as 100% (an assumed efficient cost) increased by 5% seven times in succession (the seven elements listed above), which is around 141%.

This progress will undoubtedly have closed the gap between Scottish Water's performance on investment delivery and the historical performance of the companies in England and Wales. However, it is important to note that the overall performance of the companies south of the border continues to advance. Scottish Water cannot therefore 'rest on its laurels' and must continue to improve the efficiency with which it delivers its investment programme.

### Our expectations for 2015-20

In Note 4 we outline our expectations with regard to Scottish Water's engagement with the Customer Forum to explore alternative approaches for delivering improvements, including the use of operational solutions. We consider these alternative approaches to be important opportunities to eke out the available cash resources, freeing up cash for capital investment. As we explain in Note 4, these opportunities arise from changes we are making to our regulatory approach<sup>4</sup>.

We also expect these changes to provide strong incentives on Scottish Water to continue to improve its capital efficiency. In particular, the changes should allow Scottish Water much more flexibility when planning capital expenditure than before. This will reduce costs: for example through using this flexibility to plan more strategically and to react to changing circumstances.

We therefore expect Scottish Water to demonstrate the areas of its investment plan where it plans to:

- deliver investment projects across more than one regulatory period, where this is the most efficient way to improve service; and
- invest capital in strategic initiatives that reduce overall costs to customers over the medium to long term.

Scottish Water is best placed to examine in detail its current performance in the areas outlined in this note and to act on the results. We expect Scottish Water to provide evidence, in its business plan or in other engagement with the Customer Forum, of continuing management attention and performance improvement across the range of capital efficiency opportunities outlined in this note. Based on such evidence, Scottish Water should be able to set out clearly its ambitions for further capital efficiency improvement over 2015-20.

We will of course comment on the evidence that is presented, the conclusions Scottish Water draws from this and the extent of its ambitions for 2015-20.

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<sup>4</sup> See Section 4 of the Executive Summary of our methodology for more details of these changes.

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