Strategic Review of Charges 2010-14: Summary of discussions at stakeholder workshop 4 on Scottish Water's capital expenditure

Held on Thursday 28 June in Stirling

Present from the Office of the Water Industry Commission

Alan Sutherland	Chief Executive
Ian Tait	Director of Investment and Asset Management
John Simpson	Director of Analysis
Harriet Towler	Corporate Affairs Manager

Stakeholders present

Rab Bell	Morrison Construction
Shona Bryden	Dumfries and Galloway Council
Charles Bull	Black and Veatch
Anna Chukay	Heriot Watt University
Gerry Donnelly	Lagan Group
Tom Harvie Clark	Scottish Executive
Ryan McAlindin	Fife Council
Sean McComish	Scottish Water
Andrew McCrone	Golder Consultants
Angela McTeir	Scottish Executive
Belinda Oldfield	Scottish Water
Gerard O'Loan	NHS Scotland
David Rae	North British Distillery
Alan Scott	Scottish Water
Ian Smith	Waterwatch Scotland
Alan Watt	CECA
Janet Wright	Water UK

Opening remarks

Stakeholders were welcomed to this fourth workshop for the 2010-14 price review. It was explained that this workshop, which preceded the publication of the Commission's methodology consultation for the review, would focus on how the Commission should approach its assessment of the appropriate allowance for Scottish Water's capital expenditure.

Today's meeting coincided with the publication of Volume 3 of the methodology consultation on Scottish Water's operating costs. Comments from stakeholders at the workshop on 31 May on the same subject had helped influence this document. It was noted that the Commission hopes to capture the views of as many stakeholders as possible before publishing its methodology. Attendees were invited to raise questions throughout this workshop.

It was explained that the process to define Scottish Water's capital expenditure requirements during a price review involved a number of different stakeholders and parties.

- Ministers set objectives for the industry to achieve over the regulatory control period.
- Scottish Water uses business plans to set out the investment it requires to achieve these objectives.
- WICS scrutinise these plans to ensure that they represent value for money for customers. In the final determination of prices, WICS finance the amount of investment required by Scottish Water to deliver Ministers' objectives at the lowest overall reasonable cost.

WICS methodology consultation would focus on how it should scrutinise Scottish Water's business plans to ensure that they represent value for money. In particular we sought views on the form of this scrutiny.

Issues discussed

1. What size of investment programme can be delivered efficiently?

Premise for discussion

Is there a limit on the amount of investment that Scottish Water can deliver efficiently? How much capacity is there in the construction industry to deliver Scottish Water's investment? Could too much investment flood the construction market and cause it to over-heat?

Issues raised

One attendee noted that Scottish Water had conducted analysis that suggested the £600-650m investment planned in 2007/08 is within the capacity that can be delivered efficiently over remainder of 2007-2010. However, there was a risk that there may not be sufficient capacity in the design element of the construction process in 2007/08.

Another attendee noted that fluctuations in Scottish Water's investment over the regulatory control period made it difficult for contractors to commit resources to undertake the investment plan. This problem was exacerbated by long term uncertainty over Scottish Water's investment requirements.

One attendee questioned whether there was a limit on the number of planning permissions local authorities could grant – could this create a bottle neck in the early stages of the investment programme?

Another attendee questioned how much disruption, for example from new main laying etc., communities would be willing to tolerate. It was noted that in some cases Scottish Water does not need councils' permission to conduct work on roads. In some instances councils had not been informed of the work taking place. This created difficulties if a resident made enquiries about the work.

2. Capital maintenance

Premise for discussion

New approaches to assessing, and planning, capital maintenance requirements are being developed. However, they require an extensive amount of information about assets – how can WICS compensate for the fact that Scottish Water does not yet have sufficient information to implement such an approach?

Issues raised

One attendee noted that Scottish Water needed to gain a better understanding of its assets before it could implement the capital maintenance planning techniques used by the companies and the regulator in England and Wales.

3. Scope for efficiency

Premise for discussion

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. WICS used this approach in the 2006-10 review. Is it appropriate to use the cost base approach this time? Should WICS consider other ways of establishing efficiency?

Issues discussed

One attendee noted that providing greater certainty about investment priorities in the longer term should encourage greater efficiency. In particular, it would allow both Scottish Water and the construction industry to better plan and explore more efficient solutions.

4. Smoothing fluctuations in the investment cycle

Premise for discussion

In any regulatory control period, there is a tendency for investment levels to dip in the early part of the period, and rise in the latter part. Are there underlying reasons for this? Can these fluctuations be prevented? And whose interests are best served by aiming to smooth them?

Issues discussed

One attendee noted that research had been undertaken in England and Wales to explore how fluctuations over the 5 year regulatory cycle south of the border could be smoothed. It was noted that this research was aimed at ensuring that the companies delivered the investment they had committed to. This work had explored a number of options, including 'early starts' and 'late finishes'.

One attendee noted that there was an economic incentive for companies to complete 'easier' projects earlier in the cycle, leaving the more difficult projects until later in the cycle.

Another attendee commented on whether smoothing the investment profile of water companies was in the interests of customers, or contractors.

One attendee noted that a smoother profile of investment and greater visibility as to investment requirements in the future was in the interests of customers as; it allowed time for the construction industry to explore more efficient ways of delivering investment; and it avoided the danger of over-heating the market during peaks in investment, leading to higher construction prices.

One attendee commented that the early part of the regulatory control period is often consumed by project development and gaining the necessary planning permissions for construction.

Another attendee suggested that this issue could be eased by staggering the investment allowed for over regulatory control periods. For instance, financing for planning investment for the 2014-18 regulatory control period could be allowed for in 2009 as part of the 2010-14 review. This would also increase the degree of visibility that Scottish Water and its contractors has over future investment requirements.

One attendee suggested it would be possible to 'ring-fence' planning costs in this way.

Another attendee commented that the early start that Scottish Water had been allowed to make on the 2006-10 investment programme had already had a positive effect.

However, another attendee highlighted that in order to provide greater visibility, ministerial objectives would need to be determined for longer time periods. Doing so could mean that Ministers' decisions would become more detached from the prices that customers pay. For instance, there would be less opportunity to understand how a long-term objective would impact on prices in future control periods. It would also be difficult to communicate to customers that the investment required to solve an issue such as sewer flooding, would take place in order to fulfil a ministerial objective, but would not happen for another 10 or 20 years.

Another attendee questioned whether it would be possible to commit to objectives that far in advance. It was noted that European Union Directives could impact on ministerial objectives and require changes. Would the situation arise where customers had been promised investment, only to find that priorities had changed?

One attendee questioned to what extent external factors influence the water industry, and to what extent can they be safely predicted?

One attendee questioned whether it was any more difficult to predict investment priorities eight years in advance as opposed to four. Could some objectives be 'safely' predicted and factored in to earlier price reviews?

Another attendee questioned if such long term commitment could become too restrictive, and inhibit innovation in the industry.

One attendee noted that water companies tend to use 'tried and tested' solutions to deliver investment. Such an approach was adopted as timescales were short, and the company could have confidence that they could deliver the solution efficiently. However, greater innovation could lead to a more efficient solution in the future.

One attendee questioned who should bear the risk of this innovation and experimentation. Was allowing for research and development projects consistent with delivering Ministers' objectives at the lowest overall reasonable cost?

One attendee noted that if this was not that case, the regulatory framework acted as a disincentive for innovation.

Another attendee commented that allowing greater visibility, and hence longer timescales, should reduce the risk of innovatory projects as there was more time to plan them.

5. Monitoring delivery

Premise for discussion

Ensuring objectives are delivered is an important element of providing value for money for customers. Customers should receive the outputs they have paid for. The Scottish Executive chaired Output Monitoring Group (OMG) has made a good start at scrutinising Scottish Water's investment delivery for the 2006-10 review – can it play an even more important role in the next?

Issues discussed

One attendee noted that they welcomed the concept of the OMG, but had been largely unaware of the work it was carrying out.

Another attendee noted that there was still scope for the reporting mechanisms of the OMG to develop. It was noted that monitoring of investment delivery had previously tended to focus on expenditure, rather than outputs delivered. However, focussing on expenditure provided no indication of whether Scottish Water were delivering required outputs, and whether they were doing it for more or less than expected. The OMG was an important development in changing the emphasis of monitoring in favour of what outputs were being delivered for customers.

One attendee commented that the OMG was important for Ministers as it provided them with comfort that outputs were being delivered and that their objectives were still appropriate.

END

The Commission attaches significant importance to stakeholder workshops and would welcome any further comments or feedback that interested parties may have. Comments should be sent to Harriet Towler (*harriet.towler@watercommission.co.uk* or 01786 430200).

A discussion paper, issued prior to this workshop and providing further context is available on the Commission's website at *www.watercommission.co.uk*.

A further four stakeholder workshops will be held following the publication of the Commission's consultation on the methodology for the price review.

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