water industry commission FOR SCOTLAND

4

Initial Decision Paper 4:

Overall size of the Capital Programme

This is the fourth in a series of Initial Decision Papers that the Water Industry Commission will publish during the Strategic Review of Charges 2021-27. The Commission will publish initial, revised and final Decision Papers. These Initial Decision Papers set out, for customers and other stakeholders, the Commission's current views on important matters relating to the Strategic Review of Charges 2021-27. They will 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;**
- **The potential for Scottish Water to engage even more effectively with its customers; and**
- **The approach to the Strategic Review of Charges 2021-27.**

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review[1], taking account of all the evidence currently available to it in coming to the views set out in these Initial Decision Papers.

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

This fourth Initial Decision Paper sets out the Commission's current view on the overall size of the capital programme in the next regulatory control period.

Key messages

Scottish Water will likely have to invest more in the next regulatory control period. It is likely that this increased level of annual capital expenditure is not a one-off. High levels of capital maintenance expenditure[2] will also likely be required (in real terms) in future regulatory control periods.

Scottish Water faces an ongoing requirement to invest in improving drinking water quality, environmental performance and services to customers. There are also emerging future challenges in areas such as maintaining the condition of assets, mitigating the impact of climate change and improving resilience.

There is strong evidence that Scottish Water has improved both its cost efficiency and delivery of capital investment over previous regulatory periods. Scottish Water should continue to seek out ways to improve its efficiency. This will reduce the upward pressure on customers' charges.

1 'Innovation and Collaboration: future proofing the water industry for customers', published on 10 April 2017 and available on our website.

2 Maintained in real terms

4 Initial Decision Paper 4: Overall size of the Capital Programme

Introduction

The Scottish Ministers' objectives for the water industry in Scotland will substantially dictate (before any efficiency is allowed for) the amount of capital expenditure that Scottish Water will require during a regulatory control period. Maintaining the condition and performance of the current asset stock is the other significant driver of total capital expenditure.

Capital expenditure is required to maintain and improve the assets of a company. It should not be confused with operating expenditure – the costs that a company incurs in its ongoing, day to day activities.

The Commission will set out more detailed views on the appropriate range for capital expenditure in a later Decision Paper. At this time, we consider that a capital expenditure programme in a range from £3.4 to £3.8 Billion could be considered broadly realistic. The Commission will set out its final decisions only after Scottish Water has had the opportunity to explain both the extent and the deliverability of its proposed capital expenditure programme.

Drivers of Capital Expenditure

Capital investment to maintain the condition and performance of existing assets

This is expenditure to future-proof the levels of service that customers enjoy. It involves managing the condition, performance and risk of all the assets owned and operated by Scottish Water. For example, it would include expenditure to maintain and to renew water mains and sewers or replace worn out pumping equipment. Without appropriate and effective expenditure on maintenance, assets would deteriorate, their performance would decline, and they would ultimately fail. Customers would be increasingly impacted.

Assessing an appropriate level of expenditure on maintenance is very difficult. It is likely to be even more challenging to target the expenditure on maintenance effectively. This is due in part to the uncertainty that exists around the lifetime of many, especially long life, assets and the limits on our ability to measure the impact of capital expenditure on condition, performance and risk. In our methodology[3] we explained that, given these uncertainties, companies and regulators have typically resorted to an approach of 'pay the minimum that is demonstrably required within the regulatory period.'

This approach is not consistent with protecting current and future customers from future price shocks. Scottish Water will need to continue to improve its information on asset performance, risks and condition. We will return to this topic in future Decision Papers, but it appears highly likely that a need for increased capital maintenance expenditure will be a significant driver of a larger overall programme of capital expenditure.

Capital expenditure to enhance performance and respond to growth

Enhancement capital expenditure relates to new assets or the upgrading of existing assets (either in terms of their performance or their capacity). The aim is to improve the levels of service received by customers, to facilitate economic growth by allowing for new connections to the system or to meet higher environmental or water quality standards.

Scottish Water has made significant progress in enhancing service levels over the last 15 years. However, it seems likely that there will be an ongoing requirement for further expenditure on enhancing drinking water quality and environmental performance for the foreseeable future. For example, expenditure will likely be required to remove lead from the water supply system and to improve bathing water standards. There are also a number of emerging risks in areas such as:

- flooding and network resilience;
- the need to consider the rural cost and service challenge with a view to achieving compliance with UN Sustainable Development Goal 6;[4]
- higher customer expectations; for example, on response times, water pressure issues, taste and odour; and
- issues such as mitigating climate change and protecting against cyber crime.

3 'Innovation and Collaboration: future proofing the water industry for customers', published on 10 April 2017 and available at our website.

4 UN Sustainable Development Goal 6: Ensure access to water and sanitation for all http://bit.ly/1FcK4NW

4

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Our provisional view is that expenditure on enhancement projects will be broadly similar in real terms to previous regulatory control periods. In Initial Decision Paper 1, we identified that the level of capital investment has a significant impact on customers' charges. It will therefore be essential that Scottish Water can demonstrate to customers and stakeholders that it is delivering the objectives set by the Scottish Ministers in an effective and efficient way.

Establishing capital investment requirements

In our methodology, we explained how we will ask Scottish Water to set out its proposed capital expenditure programme. In future Decision Papers, the Commission will comment on Scottish Water's proposed approach. Future Decision Papers will also consider capital maintenance, service level improvements and the capital expenditure required to increase the capacity of, or number of connections to, the water and sewerage system.

4

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