

Initial Decision Paper 8: **Enhancement Investment**

This is the eighth 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 issue 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 review¹, 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, agreed with the Customer Forum, and consistent with the Commission's Final Decision Papers as its Draft Determination.

This Initial Decision Paper sets out the Commission's current views on investment to improve levels of service and ensure compliance with legal standards for drinking water quality and environmental performance – termed 'enhancement' investment.

Key messages

In previous Strategic Reviews, the Commission has set prices based on a level of enhancement investment that reflected its review of Scottish Water's levels of service, costs and its proposed list of projects.

Scottish Water faces new challenges. The programme of environmental and service improvement investment is likely to continue at broadly similar levels of activity for the foreseeable future. Meanwhile, Scottish Water will want to make progress in ensuring that its growing asset base is being sustainably funded and maintained. Resilience (to floods, drought and operational issues) is also becoming increasingly important. Initial Decision Paper 9 will address another potentially problematic issue: rural connections and facilitating customer growth.

The Commission is keen that Scottish Water thinks strategically about what needs to be done over the next 25 years. As such, the Commission plans to set prices that allow for sustainable levels of investment over the long term and gives Scottish Water the opportunity to plan its activities in the most efficient and effective manner possible. The Commission considers that there is substantial scope to improve the way that the investment programme is defined and monitored.

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

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The Commission's expectation is that Scottish Water will explain the level of investment that it proposes in its business plan. In Initial Decision Paper 5, the Commission explained that customers, communities and stakeholders can have a reasonable expectation that Scottish Water will explain the cost effectiveness of all of its activities, including its proposals for enhancement investment.

Notwithstanding the new challenges that Scottish Water faces in prioritising its enhancement investment, the Commission expects that further improvements in the efficiency of delivery will mean more can be done for the same level of expenditure. As such, the level of required enhancement investment should be broadly similar to previous regulatory periods.

Introduction

Scottish Water receives revenue from customers of just over £1.1 billion² each year. In addition it has been able to access new borrowing of around £100 million on average each year since 2002.

On the expenditure side, operational costs (including PFI charges) and interest payments account for around £700 million. Scottish Water invests around £500 million each year. Around 50% of this investment has been for capital maintenance to maintain existing levels of service. The remaining 50% or so relates to growth (connecting new customers to the network) and enhancement investment to improve service levels, drinking water quality and environmental performance.

The Commission discussed capital maintenance in Initial Decision Paper 7. Initial Decision Paper 9 covers investment in growth and improving rural services.

Enhancing Service

Since it was formed in 2002, Scottish Water has invested £3.2 billion (outturn prices) in enhancing drinking water quality and reducing its environmental impact to comply with standards set by the European Union. Through this investment, Scottish Water has made significant progress in enhancing service levels over the last 15 years. However, it now appears inevitable that there will be an ongoing requirement for further enhancement investment. For example, expenditure will likely be required to remove lead from the water supply system and to improve bathing water standards. There is also emerging risk 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 (as discussed in Initial Decision Paper 9);
- 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 attacks.

There are, however, opportunities for Scottish Water to continue to improve the cost effectiveness of its delivery. Experience has shown that significantly better and more efficient enhancement solutions can be delivered if sufficient time and effort is invested in studying how best to deliver the required outcomes. Scottish Water reports that it has adapted its delivery processes to help ensure that there is sufficient opportunity to identify strategic, innovative and effective solutions. We would expect Scottish Water to continue to build on this experience.

The Commission's provisional view is that expenditure on enhancement projects should be broadly similar in real terms to that which Scottish Water has delivered in previous regulatory control periods. In other words, the scope for further efficiency will offset the additional expenditure that would otherwise have been required

² The figures provided are in 2016/17 prices.

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to address the new enhancement requirements. In Initial Decision Paper 1, the Commission 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.

Defining the investment programme

Scottish Water reduced its unit costs of delivering new projects significantly during its first few years. Subsequently, it has continued to improve its levels of performance and control costs. As such, it has improved its efficiency considerably since 2002.

The development of a 'Technical Expression' – which provides an agreed list of outputs to be delivered – was critical in building the initial necessary confidence that Scottish Water was making effective progress in delivering the expectations of its customers and its regulators. Scottish Water is now a much more effective organisation. In considering how best to move forward, the Commission has identified two principal weaknesses in the current use of the 'Technical Expression'.

Firstly, some projects are not fully defined and yet to be properly costed. There is no detailed understanding of what will be done to achieve the required outcome, how long it will take and how much it will cost. Including these projects at such an early stage has the potential to be misleading (and reduce the confidence of customers and stakeholders). It may be more effective separately to maintain a clear list of identified needs and a broad estimate of how much it will cost to deliver these desired outcomes. In the Commission's view, it is not helpful to monitor the progress of an individual (undefined) project through the needs definition and design phase too rigidly. Monitoring of performance may be more effective if Scottish Water was to report its progress in defining how the full list of established needs are to be met. Scottish Water could also usefully seek the views of its owner, its regulators and customers in prioritising projects. Under this arrangement, projects would only proceed to the 'Technical Expression' stage when they were fully defined, costed and agreed.

Second, the process surrounding the 'Technical Expression' may be somewhat too rigid. Initially, it was developed for the start of the regulatory control period and only relatively small changes were made in period. Scottish Water introduced a discipline of studying what is required in one regulatory control period and seeking to deliver the required asset intervention in the subsequent period. At the last Strategic Review Scottish Water built on this concept and introduced a three year 'rolling investment review'. This maintained the clarity of what was to be delivered but allowed Scottish Water to respond more quickly to the outcome of studies and new information.

Under this arrangement, Scottish Water defines in detail what it plans to do for the first three years of the regulatory control period and provides an indicative list of projects for the second three years. Half way through the regulatory control period, Scottish Water will finalise the second three years and publish a further indicative programme for the first three years of the next regulatory control period. This revised approach has, in our view, been a significant improvement.

However, there is a clear opportunity for Scottish Water to be much more flexible and respond to the needs of the statutory quality regulators, DWQR and SEPA, and other stakeholders in an even more timely fashion. There are three reasons for this:

1. The Commission proposes to allow for investment expenditure consistent with Scottish Water's 25 year strategy;
2. The detailed monitoring of the capital programme will be restricted to those projects that have been costed and defined and added to the 'Technical Expression'; and
3. The Commission's revised approach to setting prices should allow Scottish Water to improve significantly the confidence of its supply chain and deepen its partnership with contractors.

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Agreeing a level of investment that is consistent with Scottish Water's strategic plan and not tied to specific projects should make it easier for Scottish Water to deploy its resources more flexibly and seek out innovative solutions. Customers and stakeholders will justifiably expect Scottish Water to respond effectively and quickly to their needs. The scrutiny of stakeholders of projects as they are added to the revised 'Technical Expression' should ensure that Scottish Water makes the most effective possible use of the resources available to it. The Commission will review carefully, the performance report of the Scottish Water Board.

By limiting the detailed 'Technical Expression' to defined and costed projects, Scottish Water should be able to review it more frequently. This should allow more space for innovation, detailed study and the agreeing of priorities but maintain the transparency over the projects that have been agreed. The development of an agreed list of identified needs should also mean that there is not the perceived need to include ill-defined place holders in the 'Technical Expression'. The maintenance of an agreed list of needs would also help to ensure that there is regular and substantive review of these needs at the Outputs Monitoring Group and greater buy in to innovative approaches.

The potential for Scottish Water to improve and deepen relationships with its subcontractors could be expected to have three benefits:

- Lower unit costs because it should be easier to manage capacity;
- More responsive and innovative contractors (who will want to ensure they can maintain their share of the available work); and
- More efficient and effective contractors as the deployment of key skills should become easier to plan.

The Commission's proposed approach would make Scottish Water directly and immediately accountable for its programme of capital expenditure. Scottish Water could therefore manage its programme of investment strategically and adopt the most effective approach to delivering for its customers and meeting the expectations of its regulators. There should be no 'false deadlines' and more flexibility to ensure that current views of priorities can be accommodated as expeditiously as possible.