

# Strategic review of charges 2010-14: stakeholder workshops 2009

## Discussion paper 4: Investment and quality

Welcome to our fourth stakeholder workshop of 2009 on the strategic review of Scottish Water's charges for 2010-14. Later this year we will determine caps on: the amount Scottish Water can charge household customers; the 'default tariffs' that suppliers in the newly competitive market must offer business customers; and limits on the wholesale price Scottish Water charges retail suppliers.

This workshop is the fourth of eight designed to explain the high level issues we will encounter in the final stages of the price setting process. It focuses on how the investment programme that Scottish Water will be required to deliver over the regulatory period is devised and factored into price caps. Later workshops will focus on more detailed issues such as capital maintenance and capital expenditure efficiency.

This paper provides some context to the issues we will be discussing. We welcome your views and any questions you may have.

### Background to investment

Scottish Water incurs capital expenditure in two ways:

- to maintain its existing assets (its network of pipes, reservoirs and treatment works)
- to enhance its assets to deliver service improvements.

It is important to the service that customers receive, and the wider water environment, that Scottish Water invests appropriately in its assets. However, as Scottish Water's capital expenditure accounts for almost half its annual expenditure, it can have a significant impact on customers' bills.

Scottish Water targets its investment at delivering a series of objectives set by Scottish Ministers. We have a duty to set price limits at a level sufficient to finance the delivery of these objectives at the lowest overall reasonable cost. We therefore scrutinise Scottish Water's investment proposals (set out in draft business plans and later an agreed delivery plan) very carefully.

### *Investment at the last price review*

Capital expenditure was the single largest allowance at the last price review. The process to determine an appropriate level of capital expenditure involved a number of other stakeholders. It began with Ministers and a programme of consultation.

- **Ministers** set objectives for Scottish Water to achieve over the regulatory control period. These objectives related to improving drinking water quality, service to customers, development constraints and the environment.

- **Scottish Water** devised what, and how much, investment it would need to deliver these objectives. It also considered how much capital maintenance would be required. It set these proposals out in a first draft business plan, and once Ministers had clarified their objectives, a second draft business plan. Scottish Water proposed an investment programme of £3.4 billion in this second draft business plan.
- **We** asked the Reporter (a professional engineer) to scrutinise the first and second draft business plans. The Reporter highlighted a number of potential issues with the plans. These concerns related to the scope of the investment proposed, and how it had been costed. We investigated the Reporter's concerns further.
- **We** also considered Scottish Water's capital maintenance requirements. We modelled what would be an efficient level of capital maintenance.
- **We** concluded that Scottish Water could deliver all of the Ministers' objectives for £2.15 billion, representing a significant saving for customers' bills.

We are currently following a similar process at this review.

### **Progress to date**

Much of the work to devise Ministers' objectives for the 2010-14 period has already been completed. In [2004] the Scottish Government undertook a multi-stakeholder consultation process (Quality and Standards III) to formulate objectives for the 2006-10 review period. As part of this process, Ministers also considered likely objectives for the 2010-14 period. These draft objectives have been reviewed and updated by Scottish Government in discussion with stakeholders.

We expect Ministers to finalise their objectives shortly. They have already indicated that objectives will be prioritised into two groups. Priority 1 objectives must be funded and delivered during the next regulatory period. Priority 2 objectives have a lower urgency and could be deferred until the 2014-18 period. We expect to be asked to consider the extent to which Priority 2 objectives can be delivered within the parameters set by Ministers in our draft determination of charges at the end of June. Once Ministers are aware of the impact of Priority 2 objectives on prices, they will make a decision as to whether to defer these objectives until the next price review.

Scottish Water has already made good progress with its business plan. It submitted a first draft to us last year which we provided feedback on. This first draft proposed an investment programme for 2010-14 of around £1.9bn in 2007-08 prices. Scottish Water will submit its second draft business plan on 13 March. This is the plan that we will scrutinise and use to calculate price caps.

### **Our approach**

In our methodology consultation we set out a number of factors that we would consider when scrutinising Scottish Water's second draft business plan. Respondents generally supported this approach. These factors are:

**Deliverability:** what size of investment programme can Scottish Water reasonably be expected to deliver efficiently and within the four year regulatory period?

**Definition:** are the outputs that the plan sets out to deliver sufficiently well defined to allow effective monitoring?

**Ensuring effective delivery:** are the projects and solutions proposed by Scottish Water appropriate to deliver required outputs?

**Assessing the scope for efficiency:** are Scottish Water's proposed costs in line with the UK standard?

We will set out the initial conclusions we have reached in detail in our draft determination. All stakeholder will have the opportunity to comment.

### **Other important issues**

In reaching our conclusions, we will also need to consider the following issues.

**Continuity of investment between periods:** It is a characteristic of the water industry in the UK that at the beginning of the regulatory control period there is a dip in investment. This tends to be because water and sewerage companies require time to formulate exact project plans, procure assets, and contract building work before actual investment starts. It places pressure on the company at the end of the regulatory control period when investment tends to peak. We will consider if we can help mitigate these fluctuations by financing Scottish Water to make an early start on projects for the 2010-14 and 2014-18 periods.

**Uncompleted projects from previous periods:** Scottish Water has indicated that a number of projects from previous investment periods will not be completed by the start of the 2010-14 investment period. We do not intend to allow Scottish Water any extra financing to complete these projects during 2010-14: the principle being that customers will not pay twice.

**Monitoring delivery:** Ensuring objectives are delivered is an important element of providing value for money for customers. Customers should receive the outputs they have paid for. During the current regulatory period, Scottish Water's progress with its investment programme is monitored by a multi-stakeholder Output Monitoring Group. We believe this scrutiny is an important element of Scottish Water's overall regulatory framework. We expect the role of the OMG to further strengthen during 2010-14.