

Strategic Review of Charges 2010-14: Summary of discussions at stakeholder workshop 8 on Scottish Water's capital expenditure

Held on Thursday 20 September in Bridge of Allan

Present from the offices of the Water Industry Commission:

David Simpson	Deputy Chairman
Alan Sutherland	Chief Executive
Katherine Russell	Director of Corporate Affairs
Judy Tait	Analytical Assistant

Stakeholders present:

Alan Watt	CECA
David Dempsey	Lagan Construction
Kevin Galbraith	Morrison Construction
Alan Scott	Scottish Water
Jack Lord	Panel Member, Waterwatch Scotland
David Rae	North British Distillery
Bill Potts	Glasgow City Council
Sean McComish	Scottish Water
Tom May	Scottish Water Business Stream

Opening Remarks

Stakeholders were welcomed to this eighth workshop for the 2010-14 review. It was explained that this workshop, which followed the publication of volume four of the Commission's methodology consultation for the review, would focus on how the Commission should approach issues arising from Scottish Water's capital expenditure programme at the Strategic Review of Charges.

The workshop was designed to inform stakeholders who planned to respond to the Commission's consultation. Questions were invited throughout on a range of subjects related to the price review.

An outline of the importance of capital expenditure in setting prices for Scottish Water was given. This included an explanation of WICS role. It was explained that the Scottish Government decides Scottish Water's investment objectives, Scottish Water then sets out in its two draft business plans its views on the investment it would need to undertake to meet these objectives and the costs that it would incur. The Commission then examines Scottish Water's business plans. The Commission's duty is to set price caps that allow Scottish Water to deliver the Ministerial objectives at the lowest reasonable overall cost.

It was explained that at the last Strategic Review of Charges, there had been insufficient time for Scottish Water to complete its business plans because of delays in finalising the Ministerial objectives. The Commission has set out a clear timetable for this Strategic Review of Charges and has allowed Scottish Water more time to complete both its first and second draft business plans.

Some of the Ministerial objectives for 2010-14 had already been set prior to the election of a new Scottish Government. This may mean that these objectives may change or additional objectives may be set. It would be important that stakeholders took this current opportunity to influence ministerial objectives for the industry to ensure that customer preferences were taken into account.

Key Issues Discussed

Volume 4 of the methodology consultation was published on 26 July 2007. The Commission is seeking views on the following issues:

1. What are respondents views on how we propose to access the size of the investment programme that Scottish Water should be expected to deliver efficiently?
2. Do respondents have views on how we propose to define the scope of the investment?
3. What are respondents' views on how we propose to determine an appropriate allowance for capital expenditure?
4. Should we consider an application by Scottish Water for "early start" to delivering the required investment outputs for 2010-14?

5. Are the methods that we propose for monitoring Scottish Water's performance in delivering the outputs required by the regulatory contract appropriate?

1. Assessing the size of Scottish Water's Investment Programme

Premise for discussion

The size of the investment programme could have a significant impact on resources both within SW and externally (for example, construction companies). Is it therefore reasonable to take the size of the programme into account? For instance, if the investment programme is too large it could lead to inefficiencies, whilst a programme which was too small may not deliver the ministers' objectives. A large programme could cause problems in the supply chain as well as difficulties in overall programme management. There are also issues related to local authority planning plus objections from local people, for example, because of the disruption that could be caused.

In addition, Scottish Water entered the present regulatory period with a large number of incomplete projects from the previous period (a situation known as an "overhang"). Current performance to date would suggest that the overhang may increase as the regulatory period progresses.

Issues Raised

One attendee noted that it was important to maintain a smooth flow of work. The contracting industry could respond to a programme of the current level but noted that it can be difficult to mobilise sufficient resources (e.g. in design) if a large number of projects were being put through the system as a single batch.

Another attendee raised the issue of whether customers would receive value for money if Scottish Water had to continue to deliver such a large capital programme.

One attendee also noted that the 4 year regulatory control period and the absence of an 'early start' programme made the delivery of a large investment programme more difficult.

2. Defining the scope of the investment programme

Premise for discussion

Scottish Water must set out how it plans to deliver the Ministers' high level objectives in a detailed investment programme. This investment programme should be transparent and accessible, enabling businesses and communities to see when planned work is due to be carried out, and allowing all stakeholders to monitor Scottish Water's progress with delivering this programme.

It is also important that this investment programme is appropriate, and will deliver ministers' objectives, as well as delivering value for money for customers. With

regard to the latter, it is important that both capital expenditure and operating costs are considered.

Issues Raised

One attendee noted that the Commission should rely more on the Reporter and that engaging additional consultants to scrutinise the programme may not be good value for money.

Another attendee stated that the Commission should be more transparent in its review of the capital programme and that Scottish Water should have an opportunity to review the consultants' conclusions for factual accuracy.

One attendee noted that it was important that the capital programme was delivered efficiently and that, as such, reviewing the scope of what was proposed to be delivered could play an important role in protecting customers.

3. Determining an appropriate allowance for capital expenditure

Premise for discussion

Capital Maintenance

Scottish Water currently spends around £200m per annum on maintaining assets (this excludes improvement and enhancement of existing assets). Scottish Water is currently working to obtain useful data on the performance of its assets. However, does Scottish Water have sufficient knowledge about its assets to use recent advances in capital maintenance planning techniques? Are there alternative approaches we should consider?

Capital Expenditure

In the water industry, it is possible to increase capital expenditure efficiency in a number of ways: better planning; better procurement; and innovation. Procurement cost analysis is the most straightforward method for examining capital expenditure efficiency. OFWAT assesses the companies' efficiency in procuring capital projects using a cost-base approach. This requires all the companies to produce prices for a range of standardised projects. The companies' prices for the actual projects that they propose to undertake have to be consistent with the costing approach taken in producing the estimates for the standardised projects. The comparison of the standardised projects (weighted to their importance in a company's capital expenditure programme) allows robust assessment of procurement efficiency to be arrived at. This approach was used in Scotland at the last Strategic Review of Charges.

Issues Raised

One attendee noted that a piecemeal approach was often taken to capital maintenance planning as a consequence of the focus on addressing environmental issues.

Other attendees commented on how climate change and European Union (EU) environmental legislation could affect the capital expenditure programme:

- Some attendees expressed the view that the challenges of meeting carbon reduction targets could increase the costs faced by Scottish Water.
- Another attendee expressed a cautionary note. He said that Scottish Water would need to be careful and not take expensive initiatives, which could in the future become redundant due to changes in political priorities.

4. Appropriateness of an “early start” to Scottish Water’s investment programme

Premise for discussion

During regulatory control periods, investment levels tend to fluctuate – there tends to be a dip in investment during the early stages of the regulatory control period when planning takes place. There is often a pressure to deliver a lot of investment in the final years of a regulatory control period. It may be that short regulatory control periods could make this worse. An “early start” to meeting the objectives of the 2010-14 regulatory period could help. This would require much greater visibility about ministerial objectives. It would be useful to have completed the design, definition and land purchase for a substantial part of the 2010-14 programme before March 2010. However, over what time period could ministerial objectives be set?

Issues Raised

One attendee explained why Scottish Water had made a slow start to delivering its capital investment programme. It could not hire contractors until Scottish Water had certainty on its level of revenue. These delays were exacerbated by the availability of contractors, particularly in design.

Another attendee commented on the lack of flexibility resulting from a system which centred on ministerial directions and the WICS final determination.

Two attendees raised the problem of working on a four year regulatory cycle. They said it would be better to work on a ten year cycle. If, we could, get ‘early start’ to work and Scottish Water had had at least several years visibility of ministerial objectives, there could be more efficient delivery of the capital programme, compared with the benefits of working to a longer, say ten year, cycle. The creation of rolling cycles would afford the capital expenditure programme greater stability.

One attendee asked whether the Scottish Government could extend the length of a regulatory control period. He noted that there were certain investment objectives that could be decided with confidence several years in advance. This could include maintenance and major environmental improvements. He felt that these projects were unlikely to be contentious and, as such, around 70-85% of the programme could be satisfactorily defined in advance.

One attendee asked if there was scope to change ministerial objectives in order to minimise the likely investment overhang at the end of this regulatory control period.

5. Monitoring Scottish Water's delivery of investment outputs

Premise for discussion

Progress had been made in the last few months in our monitoring of investment outputs. This has resulted in a better understanding of the flow of projects through the system.

Is there scope to improve further our monitoring of Scottish Water's delivery of investment outputs?

Issues Raised

One attendee asked about the effectiveness of the Output Monitoring Group.

One attendee highlighted that Scottish Water ought to use the media when it opens new facilities. This should be a source of positive PR and responding positively to any comments about the industry.

One attendee observed that Scottish Water was monitored on its delivery of the ministerial objectives, rather than on expenditure. This could add to its view of risk being taken on a project by project basis and not across the entire programme.

One attendee commented that Scottish Water was already working on its 2010-14 business plan detail. This was possible because the Minister had given an early indication of the objectives for 2010-14. These had been formulated as part of the Quality and Standards III process.

6. Wider issues discussed

Premise for discussion

The above discussion on output monitoring led on to a wider discussion on the role of the Reporter in the development of Scottish Water's draft business plans.

Issues Raised

There was some discussion regarding the submission of Scottish Water's draft business plans and why two were required.

One attendee noted that the Reporter's challenges to the business plan added value and increased the benefit to customers. Savings could be made via this challenging process. These savings were much greater than the costs of the Reporter.

One attendee asked if the business plan process was a major distraction to the management of Scottish Water.

END