

Section 6 - Enhancement Capital Expenditure

Introduction

Section 6 collects actual and forecast capital expenditure associated with schemes for enhancement, such as: new quality obligations, enhanced levels of service and the provision of additional supply/demand capacity. Expenditure must be expressed in 2007-08 prices, using COPI. All other capital expenditure should be reported in Section 5 - Maintaining Service and Serviceability to Customers.

Schemes that jointly satisfy enhancement and maintenance drivers will appear in both Sections (5 and 6), with the total scheme expenditure allocated accordingly between the two sections.

Section 6 separately identifies expenditure for the water and wastewater services, and also distinguishes between infrastructure and non-infrastructure expenditure. Scottish Water should report its enhancement expenditure in the following four tables:

- Table 1 - Water infrastructure enhancement expenditure
- Table 2 - Water non-infrastructure enhancement expenditure
- Table 3 - Wastewater infrastructure enhancement expenditure
- Table 4 - Wastewater non-infrastructure enhancement expenditure

Where enhancement schemes affect both infrastructure and non-infrastructure assets, the expenditure should be allocated accordingly between the tables. Similarly, if any scheme applies to both water and wastewater, then an appropriate allocation should be made.

The four tables follow a common format to collect actual and forecast enhancement expenditure for each year from 2002-03 to 2017-18 and the average of the next four years. Each table accommodates expenditure for the three programmes: Quality and Standards 2, 3a and 3b.

Block A in each table contains a single line for all Quality and Standards 2 enhancement expenditure. Scottish Water should explain in its commentary what Q&S2 schemes, if any, are expected to incur investment during the 2010-14 plan period, and the reasons they are delayed to this extent.

Three lines in Blocks B and C are provided for Quality and Standards 3a and 3b to separately identify: customer service and retail, supply demand and the remainder relevant to the particular service (drinking water or environmental wastewater). It is assumed there will be no environmental expenditure within the water service and more obviously, no drinking water expenditure within the wastewater service. These blocks should include, in the appropriate report years, any "early start" expenditure proposed by Scottish Water.

Blocks D and E allow Scottish Water to enter details of expenditure savings arising from: synergies with the capital maintenance programme, other functional overlaps and capital efficiency. Scottish Water should discuss these lines in its commentary, particularly if returning a zero entry.

Block F contains calculated totals.

Block G provides Scottish Water an opportunity to enter any desired early start Scottish Water believes would materially contribute to a smooth and efficient resource transition between Quality & Standards periods 3a and 3b (in 2007-08 to 2009-10) and between Quality and Standards 3b and 4 (in 2010-11 to 2013-14). It should be noted that our approach has changed for this Business Plan and any 'early start' expenditure must already be included in the SR 2010-14 expenditure reported in Line 9. Scottish Water should include in its commentary a breakdown of any desired 'early start' expenditure, setting out how it believes this will benefit the business.

Scottish Water guidance

Scottish Water should set out in section 6 of its commentary, an overview of its proposed enhancement programmes for the water and sewage services. Detailed scheme-specific information will be provided in the 'Investment and Output Plan', and this must reconcile with the Tables and commentary in this section

Scottish Water should explain in its commentary the justification for its proposed Q&S3b enhancement expenditure programme, showing clearly how the proposals link to Ministerial Objectives.

We suggest Scottish Water's commentary discusses each proposed investment area separately, for example (but not exclusively):

- Drinking Water Quality Improvements
- Environmental Performance Improvements
- Customer Service improvements
- Growth and First Time Provision

Scottish Water should set out any important enhancement issues and how any new legislation or guidance has been translated into capital schemes. Scottish Water's interpretation of relevant ministerial guidance and the timescale for carrying out the work on improvements needs to be set out.

Scottish Water should include in its commentary a summary of any changes to the assumptions made for the period 2006-10 as a result of differences in legal obligations. Scottish Water should also explain and value any late output delivery compared with the assumptions and outputs set down at the last review of charges.

Scottish Water should include, in its enhancement investment proposals, provision for "early start" investment for Q&S3b and Q&S4, which is consistent with allowing an ordered transition of work between investment periods and improved procurement efficiency. The accompanying commentary should detail the "early start" component of the expenditure proposals and provide a justification for each element of the early start programme.

Scottish Water should set out its sludge management strategy. We expect to see evidence that alternative strategies have been considered and that the chosen strategy provides an optimal balance between cost-effectiveness, environmental sustainability, flexibility and economic/business risk. We also seek confirmation that the chosen strategy is in line with legislation and codes of practice, both current and anticipated.

The commentary should highlight and explain any changes in the strategy from that set out in its previous business plan.

Capital Efficiency

When costing capital schemes, Scottish Water should decide on the scope for improving its efficiency through the plan period. Any constraints on making maximum use of this scope should be explained.

Scottish Water should:

- Set out its views on the scope for improvements in efficiency and identify the supporting evidence
- Explain how the supporting evidence leads to its assumptions about cost reductions from base year levels
- Describe how the assumed improvements have been incorporated in the business plan expenditure projections

These judgements should be informed by a view of:

- Stakeholder expectations for efficiency improvements
- Relative efficiency or inefficiency to other companies in the regulated industry
- The findings of any benchmarking studies carried out
- Expectations of improving technology
- Scottish Water's recent trends in capital cost efficiency

Scottish Water should refer to any benchmarking studies it has conducted and explain how these and other studies have informed the assessments.

Scottish Water should make its assessments of relative efficiency using 2007-08 as the base year.

Scottish Water should explain in commentary how it intends to meet its efficiency assumptions. We also seek confirmation that its efficiency assumptions can be met, without increasing the risk of service or quality compliance failure.

For capital enhancements, the efficiency assessment should be made relative to current estimates of the projected cost of meeting quality obligations, enhancing service standards and maintaining the supply demand balance. Efficiency improvements will therefore be relative to the current unit cost models used to generate the investment projections for this category of expenditure. Efficiency improvements may result from either projected reduction in capital unit costs, or from anticipated adoption of new technologies and practices.

Expenditure forecasting and allocation

Scottish Water should set out its approach to forecasting all capital expenditure in its commentary to Section 5 - Maintaining Service and Serviceability to Customers.

Reporter Guidance

The Reporter should comment on the following:

- How well the Q&S3b enhancement programme reflects ministerial objectives and any SEPA or DWQR statements
- The accuracy and consistency with which Scottish Water has separated enhancement from maintenance expenditure, including the allocation of joint schemes
- The accuracy and consistency with which Scottish Water has summated and transposed enhancement expenditure from the Investment and Output Plan
- The accuracy and consistency with which Scottish Water has allocated Q&S3a and Q&S3b enhancement expenditure between the three table lines for each programme
- How thoroughly Scottish Water has examined its Q&S3b enhancement programme to identify expenditure savings arising from synergies with its proposed capital maintenance schemes
- How thoroughly Scottish Water has examined its Q&S3b enhancement programme to identify expenditure savings arising from overlaps with other programmed work
- How Scottish Water has estimated its future capital costs, the robustness of the adopted process, and whether pre-efficiency forecasts accurately reflect base year prices. The Reporter should challenge Scottish Water on: the basis of its cost estimates, the clarity of supporting information and the links between planned outputs and proposed investment
- Whether Scottish Water is reporting soundly based efficiency savings compared with the base year (2007-08) using reasonable assumptions, without increasing the risk of service or quality compliance failure
- Whether Scottish Water has correctly and consistently allocated expenditure to infrastructure and non-infrastructure in accordance with RAR2
- The robustness of Scottish Water's business justification for any desired 'early start' expenditure
- The completeness of the Scottish Water sludge strategy, and whether it is an optimal choice resulting from the comparison of different alternative approaches