

## Scottish Water's draft business plan: Enhancement expenditure

**Scottish Water published its draft business plan on 30 October 2013. This note is one of a series that the Commission is publishing to provide an objective assessment of the plan and to facilitate discussions between the Customer Forum, Scottish Water and other relevant stakeholders.**

**The Commission is aware that Scottish Water and the Customer Forum have been in regular and detailed discussion over many months. In drafting these notes the Commission has been briefed by the Customer Forum on its emerging thinking having seen the draft business plan as it was being developed. As such the notes contain advice on areas that the Customer Forum has identified as being important to it.**

**The notes highlight the strengths of the business plan and areas where the Customer Forum may wish to focus its discussions with the company. Although each note focuses on specific areas of the plan that are material to customers, final decisions should be taken 'in the round', reflecting the overall package of price and service levels agreed between the Customer Forum and Scottish Water.**

### Introduction

As the Commission described in its methodology<sup>1</sup> the water and sewerage industry in Scotland is governed by a clear regulatory framework.

The Scottish Government sets out its high-level objectives<sup>2</sup> for the water industry. In setting these objectives, the Scottish Government takes into account its available borrowing, the likely affordability of charges and the level of investment that can be efficiently delivered. The Commission's role is to set charges that are consistent with the lowest reasonable overall cost of delivering these objectives. The charges it sets must also be consistent with the Scottish Government's 'principles of charging'.

The Scottish Environment Protection Agency (SEPA) and the Drinking Water Quality Regulator (DWQR) advise the Scottish Government on the improvements needed to achieve compliance with statutory standards and other measures they believe are required to maintain public health and the environment. They also monitor and report on Scottish Water's performance against these standards.

Scottish Water's business plan sets out its proposed investment to meet the Scottish Government's objectives for the 2015-21 period. This includes investment to deliver two categories of improvements:

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<sup>1</sup> The Strategic Review of Charges 2015-21: Innovation and choice', May 2013.

<sup>2</sup> The Scottish Government's draft objectives for the 2015-27 period are set out in Appendix 3 of Scottish Water's draft business plan and will be finalised in June 2014.

- The statutory requirements that are specified in the objectives and are overseen by SEPA, DWQR or the Scottish Government.
- Other improvements that are included within the ministerial objectives but are less clearly defined than the statutory improvements, such as improvements in resilience of supply, levels of service and actions to reduce sewer flooding.

In addition to the requirements that are set out in the Scottish Government's draft objectives, the Customer Forum, in consultation with Scottish Water and other stakeholders, may also propose other outcomes that are beneficial for customers and can be delivered within the principles of charging. The scope for these additional outcomes is discussed in Note 20 for the Customer Forum. The Forum and Scottish Water would invite the Scottish Government to incorporate any such agreed additional outcomes into their objectives for the regulatory control period.

In its discussions, the Customer Forum may wish to consider the timing and pace of the investment programme, the level of innovation, the use of revenue solutions (as opposed to capital expenditure) and the company's overall efficiency. It cannot question the need to meet statutory outcomes or deadlines, specified by the Government.

There are significant opportunities for innovation in delivering the enhancement programme, particularly in the non-statutory elements that are not subject to compliance deadlines. Scottish Water's business plan sets out its approach to innovation. The Innovation Panel may be able to help the Forum in its assessment of Scottish Water's plans.

During the regulatory control period industry stakeholders (the Scottish Government, Scottish Water, the Commission, SEPA, DWQR and Consumer Futures) meet quarterly to review Scottish Water's progress in delivering the agreed objectives.

### Overview of business plan proposals

#### Investment in capital enhancement

Scottish Water proposes to invest a total of £1,089 million (in 2012-13 prices) on enhancing services over the period 2015-21 (or an average annual expenditure of £181.5 million). The six-year figure includes £182.8 million on investment to complete projects scheduled for delivery in 2010-15 but which will not be completed until the 2015-21 period. Scottish Water proposes that this completion expenditure is ring-fenced.

The breakdown is set out in the following table:

### Scottish Water's proposed enhancement investment (£m) (2012-13 prices)

Category	Statutory	Scope for discussion	Scottish Water's proposed investment (£m) (2012-13 prices)
To improve water service	340.5	130	470.5
To improve the environment	196.4	166.2	362.6
To support communities	0	73.1	73.1
<b>Total enhancement (exc. completion)</b>	536.9	369.3	<b>906.2</b>
Completion	179.8	3	182.8
<b>Total enhancement (inc. completion)</b>	716.7	372.3	<b>1,089</b>

### Impact of capital enhancement on operating expenditure

When Scottish Water invests in improving water quality or the environment, it will also incur additional operating expenditure. Scottish Water's draft business plan suggests that this additional operating expenditure will amount to £3 million<sup>3</sup> a year by the end of the regulatory control period. A large part of this expenditure is likely to include increased energy use: such expenditure may consequently increase faster than the general rate of inflation if recent trends were to continue.

### Impact of capital efficiency

The cost of the enhancement programme will be influenced by the extent to which Scottish Water can continue to improve the efficiency of its planning and delivery mechanisms. Scottish Water has proposed an overall average capital efficiency target of around 16% in its plan.<sup>4</sup>

## Our analysis and issues arising

### Investment in capital enhancement

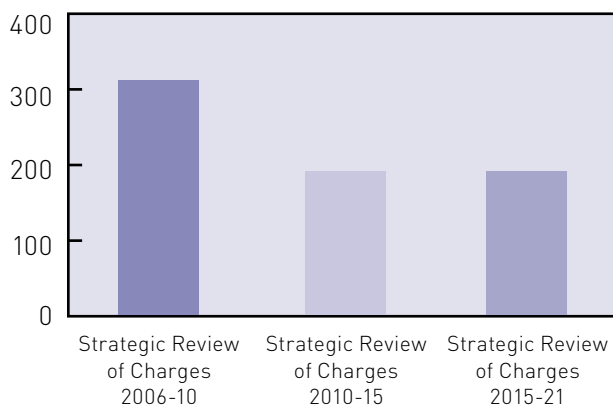
The graph below shows the average annual enhancement expenditure in 2006-10 and 2010-15<sup>5</sup> compared with the forecast enhancement expenditure for 2015-21.

<sup>3</sup> This figure is from Scottish Water's reported new operating costs in quality and service improvement. It excludes reductions in operational expenditure due to 'invest to save'.

<sup>4</sup> For the enhancement elements of the programme the average efficiency is around 12% or £151 million.

<sup>5</sup> Based on actual expenditure for 2010-13 and forecast expenditure for 2013-15.

## Average enhancement investment per year including completion (£m) (2012-13 prices)



There was agreement among all stakeholders in Scotland that, although the improvements required in the 2002-06 programme were necessary, it required Scottish Water to deliver a very high level of investment per connected property. This level of investment could not reasonably be maintained as it was greater on a per connected property basis than that required of even the small water companies in England and Wales (who would normally be disadvantaged in this regard). As the levels of investment in maintenance also had to increase, it was necessary to deliver lower levels of enhancement investment to ensure the most effective delivery possible.

### Investment in statutory enhancement

SEPA and DWQR have indicated that they are content that the statutory enhancement programme of improvements set out in the draft business plan will meet the requirements that the Scottish Ministers have set out in the draft objectives. SEPA and the Scottish Government have advised that the proposed deferral of improvements required under the Water Framework Directive will not meet the statutory compliance dates. Consequently, around £12 million of additional investment will need to be included in the 2015-21 period.

The Customer Forum may wish to confirm with SEPA and DWQR that the required statutory improvements are being delivered in a timely way; they may also wish to consider whether there has been sufficient regard to the use of innovative approaches.

### Investment in other priorities included in the ministerial objectives

The proposed enhancement expenditure for 2015-21 includes a significant element – some 34% of the total – which is included to improve the resilience and/or quality of services provided to customers and to improve Scottish Water's performance against measures that are monitored by the quality regulators and by the Commission.

For its part, the Commission considers that there is scope for Scottish Water to set out more clearly what benefits customers, as well as other stakeholders, will receive from Scottish Water's proposed non-statutory investment. For example, the proposed investment in improved resilience of the network and in customer service needs to be carefully defined, with clear, measurable outcomes and progress milestones agreed. The Customer Forum may wish to understand better the views of SEPA and DWQR in the areas that they monitor.

### **Investment to support communities**

This expenditure includes investment on energy efficiency, research, renewable generation, metering improvements, climate change and improvements to customer contacts where the Scottish Government's objectives allow for interpretation of the precise requirements. Again, the Customer Forum may wish to discuss with Scottish Water the precise nature of the benefits for customers in these areas and how the proposed improvements in performance can be properly assessed, as well as discussing the extent of desirable improvements in these areas with other stakeholders.

### **Possible duplications**

In examining Scottish Water's detailed proposals, the Commission has noted that there may be some minor duplication of drivers in the water quality programme with requirements set out in previous investment periods. The Commission is discussing these elements with the DWQR and will notify the Customer Forum of the outcome of these discussions.

### **Impact of capital enhancement on operating expenditure**

The stated impacts of Scottish Water's proposed investments on operating expenditure over the period 2015-21 amount to 2%<sup>6</sup> of the proposed investment in enhancement. In the Commission's view this is reasonable, albeit at the lower end of a typical range. It appears consistent with the overall view on operating costs that was discussed in Note 18 for the Customer Forum, although it will be important to ensure that good performance in this area is associated with efficient delivery rather than any over-reliance on capital solutions.

### **Scope for capital efficiency**

The Commission has carefully scrutinised Scottish Water's proposed capital efficiency target. We believe that this target is in excess of the challenge that would have resulted from the traditional Ofwat approach to narrowing the gap and from the more challenging approach that we used in previous price reviews.

Clearly an efficiency requires that at least the same outcome (in terms of levels of service and risk) is delivered for no more than the amount of expenditure (current and future) that was previously required. In our view, this underlines the importance of setting defined levels of service targets, agreeing potential new metrics, and introducing milestones to monitor performance towards the agreed outcomes.

The Customer Forum may wish to emphasise the importance of customer service measures and milestones in providing continuing reassurance that Scottish Water is achieving the capital expenditure efficiency targets that it has set itself.

### **Carry-over investment**

Scottish Water's proposed investment carry-over includes a significant element for on-going work on Glasgow's drainage system. There are also a number of other carry-over projects where the timescales for delivery were always expected to extend beyond the end of the current regulatory control period due to the requirement for detailed study work to determine the most cost-effective solution.

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<sup>6</sup> This figure is calculated from Scottish Water's reported new operating costs in quality and service improvement of £3 million a year over the period (total £18 million) as a percentage of the enhancement investment in quality and service improvement.

The Commission considers the proposed expenditure in these areas to be reasonable although the Customer Forum may wish to seek confirmation of the timescales for delivering the associated benefits to customers.

### Measuring performance

The delivery of the enhancement programme is closely monitored through the multi-stakeholder Outputs Monitoring Group<sup>7</sup>. The monitoring mechanisms include a measure of overall performance and detailed assessment of performance against a range of delivery milestones. The Customer Forum may wish to provide recommendations to the Outputs Monitoring Group with regards to the monitoring regime for 2015-21 to ensure that it adequately captures delivery of all of the outputs that customers have financed for the period.

Levels of service monitoring also provides assurance that outcomes are being delivered. Note 19 for the Customer Forum sets out the Commission's views on the performance indicators that the Forum may wish to see established in this area. There is scope for the Customer Forum, when developing new measures in this area, to consider how the monitoring of output delivery might be linked more directly to the overall customer experience measures. The aim would be to ensure that there is a demonstrable customer benefit from all of the non-statutory elements of the enhancement programme.

### Conclusion

The Commission broadly welcomes the proposed investment in capital enhancement within Scottish Water's draft business plan for the period 2015-21. We would highlight the importance of clear explanations from Scottish Water that set out in detail how and when customers and other stakeholders will benefit from this important element of the investment programme. There is undoubtedly scope for the Customer Forum to work with stakeholders to develop better measures in this area and for these to be incorporated into the ministerial objectives. The Commission would be happy to work with the Customer Forum to take work in this area forward with Scottish Water.

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<sup>7</sup> The Outputs Monitoring Group membership comprises SEPA, DWQR, the Commission, Consumer Futures, Scottish Government (which acts as the Chair) and Scottish Water. It meets quarterly and its reports are available on the Scottish Government's website.

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