Our work in regulating the Scottish water industry:

Summary of responses to our methodology consultation and our conclusions

WATER INDUSTRY COMMISSIONER FOR SCOTLAND

Water Industry Commissioner for Scotland
Ochil House Springkerse Business Park Stirling FK7 7XE
telephone: 01786 430 200
facsimile: 01786 462 018
email: SRCMethodology@watercommissioner.co.uk
www.watercommissioner.co.uk

May 2005

Contents

Foreword

My primary role is to promote the interests of customers of Scottish Water. One of my most important duties is to advise the Scottish Ministers on the amount of revenue that Scottish Water needs to provide a sustainable service to customers and to fund its investment programme. In the light of changes to the regulatory framework that are due to come into effect in summer 2005, Ministers asked me to prepare advice in the form of a draft determination of charges. The new Water Industry Commission, which will be established later in 2005, will be responsible for reviewing representations about my draft determination and will then prepare and consult upon a final determination of charges for 2006-10.

My draft determination will outline the price and revenue implications for customers of Scottish Water for the period 2006-10.

The last Strategic Review of Charges covered the period 2002-06. Customers rightly expect us to have built on progress since the last review, and our approach for the 2006-10 review is a development of our approach at the last review.

The principal aims of this Strategic Review are to ensure that:

- prices are set at the lowest level that is consistent with delivering the Ministers' objectives, as set out in their February guidance;
- Scottish Water invests efficiently and effectively and consequently will deliver the desired environmental, public health and customer service improvements as efficiently and effectively as possible; and
- Scottish Water further narrows the gap between its performance and that of the companies south of the border.

We consulted on our proposed approach to the Strategic Review in a series of methodology consultation documents which we published in several volumes from July to December 2004. The questions that we asked stakeholders in the methodology consultation are set out in Appendix 1.

This document provides a summary of the responses to the consultation. Responses are set out in full in Appendix 2. We also set out our current thinking on the appropriate approach we should adopt on each matter, having taken account of these responses. We have, however, recently received Scottish Water's second draft business plan which we are considering carefully. The views expressed here are therefore provisional pending publication of a full statement in the form of the draft determination of charges.

Alan D A Sutherland
Water Industry Commissioner for Scotland
May 2005

Chapter 1
Introduction

Our methodology consultation

The Water Industry Commissioner for Scotland is responsible for the economic and customer service regulation of Scottish Water.

At the end of June 2005 we will publish a draft determination, which will present our preliminary conclusions from the *Strategic Review of Charges 2006-10*. There will then be a period until 5 September during which stakeholders can comment on the draft determination and the price caps we consider to be appropriate. The new Water Industry Commission for Scotland will then proceed to determine prices under the new regulatory framework by November 2005. These prices will take effect from April 2006.

Between July and December 2004 we published a series of five information and consultation documents to support our *Strategic Review of Charges 2006-10*. These set out our proposed methodology and approach for the Strategic Review and invited stakeholders' responses on the issues raised.

The documents we published are shown in Table 1. They are all available on our website.

Table 1: Consultation documents published

Volume	Title	Published	Responses requested by:
1	Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges 2006-10	22/07/04	29/09/04
2	Our work in regulating the Scottish water industry: Background to and framework for the Strategic Review of Charges 2006-10	13/08/04	29/09/04
3	Our work in regulating the Scottish water industry: How we intend to set prices in the Strategic Review of Charges 2006-10	22/09/04	29/10/04
4	Our work in regulating the Scottish water industry: How we intend to assess operating efficiency in the Strategic Review of Charges 2006-10	07/10/04	05/11/04
5	Our work in regulating the Scottish water industry: The scope for capital investment efficiency	17/12/04	17/1/05

All of the documents that we published concerning the review reflect our intention to provide an open and transparent process. This is in accordance with our commitment to the Better Regulation Task Force principles of:

- accountability;
- transparency;
- proportionality;
- consistency, and
- targeting.

When the documents were published we contacted 193 individuals and 137 organisations, including local authorities and water companies, to tell them that the reports had been published and to invite them to respond to the issues raised.

In order to support the consultation process we also held a number of stakeholder information days and workshops. These were outlined in Volume 1 of our methodology consultation and a summary of the issues raised at these events can be found on our website.

This document summarises the responses we received to the methodology consultations. It explains any changes we are minded to make to our proposed methodology in light of the consultation responses, as well as indicating those issues which are still under consideration.

This document follows the structure that we used for the methodology consultation volumes that we published. It covers the following key areas:

- our work plan;
- the regulatory framework in Scotland and the lessons learned from the *Strategic Review of Charges 2002-06*;
- the calculation of prices;
- the scope for efficiency – operating cost; and
- the scope for efficiency – capital expenditure.

Responses received

We received responses from 17 organisations or individuals. Most stakeholders responded to specific issues that we raised in the consultation documents, although some responses were more general. Some respondents covered issues that were raised in a number of the volumes; others responded to issues that were covered in one or two volumes only[1].

The following organisations or individuals responded to our methodology consultation:

Aberdeen Environmental Services
Dumfries and Galloway Council
East Ayrshire Council
Fife Council
Glasgow City Council
Highland Council
North Lanarkshire Council
John MacNicol
Robert Miller-Bakewell
Northumbrian Water International
Perth and Kinross Council
Scottish Consumer Council
Scottish Environment Protection Agency
Scottish Water
Severn Trent
Professor David Simpson
Water UK

We would like to thank the respondents for their comments and suggestions, which we have found very helpful.

We received some criticism from two respondents concerning the short timescale for the consultation. We recognise that the consultation periods for certain volumes of the methodology were shorter than the period recommended by the Cabinet Office. This is, however, as a result of the difficulty we have had in defining the baseline investment programme for the current regulatory control period. We have taken into account all responses received, even if they arrived after the official deadline for submission of comments. Indeed, we continue to welcome comments and queries from stakeholders.

[1] We had advised that we would publish all responses to our consultation unless a respondent specifically asked for their response to remain confidential.

Chapter 2
Our work plan, the regulatory framework and lessons learned from the last Strategic Review

Volume 1 of our methodology consultation set out in detail our forward work programme for the *Strategic Review of Charges 2006-10*. We explained:

- the role of regulation;
- the information we use;
- how we intend to ensure transparency and accountability during the Strategic Review of Charges;
- opportunities for stakeholders to have their say; and
- a detailed work plan and timetable for the Strategic Review.

In Volume 2 we outlined the background to our work in assessing the appropriate level of prices. The document was presented in two parts. Section 1 provided background information about the review and explained the current regulatory framework. Section 2 discussed the changes to the regulatory framework that are taking place and the impact that these changes will have both for regulation and for customers.

In particular it covered:

- the principles underlying the *Strategic Review of Charges 2002-06*;
- reactions to, and lessons to be learned from, the *Strategic Review of Charges 2002-06*; and
- changes to the regulatory framework since the last review, including:
  - the movement to powers of determination;
  - separation of core and non-core services;
  - retail competition;
  - trade effluent charging;
  - business plans; and
  - the appointment of a Reporter.

Although we did not present any specific questions for consultation for Volumes 1 and 2, we did invite stakeholders to comment if they so wished.

One respondent asserted that decisions about changes to the methodology were being made in a relatively short time. Another welcomed the appointment of a Reporter. A third respondent expressed the view that both Volumes 1 and 2 were comprehensive and their contents reasonable.

Chapter 3
The calculation of prices

Introduction

In Volume 3 of our methodology consultation we described how prices would be calculated for Scottish Water for the regulatory period 2006-10. The document examined:

- the costs that have to be recovered by Scottish Water;
- the way prices are calculated;
- how adjustments to prices are made when circumstances change; and
- how financial risk is managed in the public sector.

We address responses to the questions posed in Volume 3 in the order they were asked in our methodology consultation.

Depreciation

Our methodology consultation explained that for the Strategic Review of Charges we proposed to:

- use a five-step classification of asset life, ranging from very short to long;
- assume straight-line depreciation over the life of the asset; and
- establish the economic value of the asset on the basis of a Modern Equivalent Asset (MEA) valuation.

This approach is consistent with that which is used for the water industry in England and Wales and in most other utilities. We explained that the approach would, in our view, provide customers with the most reliable way to assess the value of the asset base and would achieve an equitable balance between costs incurred by current and future generations.

Respondents generally supported our proposed approach to calculating depreciation and agreed with the way we planned to apportion depreciation to various asset life categories. They also generally agreed with using the MEA valuation to estimate the economic value of Scottish Water's assets.

Respondents provided different views about how depreciation should be calculated. However, no respondent disagreed with straight-line depreciation in principle.

We have noted the concerns that were expressed about differences between Scottish Water's asset base and the asset base of companies in England and Wales. However, on balance, we are still minded to use the approach we set out in our methodology consultation to calculate depreciation.

Managing risk in the public sector

Water and sewerage businesses are exposed to operational, legal and asset risks which could affect their compliance with public health or environmental standards. They are also exposed to financing risks. We seek to minimise the extent to which Scottish Water's customers are exposed to such risks.

In our methodology consultation we explained that we proposed to adopt the following approaches to managing risk at the 2006-10 review. They appeared to us to offer significant benefits for customers, while allowing Scottish Water to manage its business:

- adopt the Regulatory Capital Value (RCV) approach to price setting (see below);
- introduce effective controls on access to borrowing;
- extend our risk analysis to include financial indicators; and
- fund maintenance appropriately, with depreciation recognised accordingly.

Respondents agreed that access to borrowing should require Scottish Water to conform to the same disciplines and controls that apply in the private sector. One respondent felt that any other approach would imply that public sector capital should be treated less carefully than private sector capital.

The report that we commissioned from ING Barings considered further the issue of effective controls on access to borrowing. Its report, along with recommendations, is available on our website. The report suggested some steps that could be introduced to ensure that Scottish Water conformed with the discipline of private finance while continuing to borrow from the public purse.

Respondents agreed with the proposal to extend risk analysis to cover financial ratio comparisons. One of the main ways we can ensure that Scottish Water is subject to the same disciplines and controls as companies south of the border is by using the same financial ratios that are used in the water industry in England and Wales.

In our methodology we signalled our belief that customers should not pay for a failure to meet agreed targets. Managers of Scottish Water must face a strong incentive to ensure that efficiency targets are achieved. We therefore propose to set prices on the assumption that Scottish Water has achieved its operating cost efficiency targets for the 2002-06 regulatory control period. We discuss in Chapter 5 the approach we are minded to take with regard to the *Quality and Standards II* programme that remains to be delivered.

With regard to future price determinations, our methodology consultation explained that we are minded to assume that Scottish Water will have delivered Ministers' objectives within the price caps set in the final determination to be published in November this year. This is consistent with the guidance on the principles of charging that we received from the Scottish Ministers.

Most respondents agreed with this principle. One respondent highlighted this as being particularly important, as failure could mainly result from issues that are within the control of managers.

Scottish Water argued that at each Strategic Review, prices should be reset in line with actual costs. This, it asserted, is a fundamental principle of a price cap regime. We agree with this statement in cases where costs are unavoidably higher than assumed at price setting. However, we believe that the new Water Industry Commission should capture this effect through the interim determination and logging up and down processes. We expect to adopt the same rules for interim determinations and logging up/down as Ofwat. We outlined the main elements of these processes in Volume 3 of our methodology consultation. If Scottish Water does not meet the level of performance set out in its regulatory contract, it will be for Scottish Ministers (as the de facto owner) to decide on an appropriate course of action. In our view, such a course of action should not have an adverse impact on customers.

Our methodology consultation asked whether any other factors needed to be taken into account in minimising the risk to customers. Scottish Water's response indicated that it intended to comment further on the range of risks to which it is exposed. We will consider in detail all of the information that Scottish Water provides to us.

How we propose to determine charges for the 2006-10 period

Our methodology consultation explained that we proposed to make some changes to our approach to price setting. In particular, we plan to introduce a regulatory capital value for Scottish Water. Scottish Water would receive an appropriate rate of return on this RCV. Efficient investment in new assets will be added to the RCV and depreciation (reflecting the costs of using existing assets) will reduce the RCV.

Introducing the RCV method of price setting will also ensure that stakeholders can more easily compare the financing of the industry in Scotland with that south of the border. It will be easier to monitor Scottish Water's progress in delivering its capital programme and improving its operating cost efficiency.

Most respondents agreed with our proposed approach.

One respondent, however, considered that an RCV framework itself does not facilitate comparisons with England and Wales and that a number of factors render comparisons between the two less valid.

Under the current system, we provided advice on a single, general cap on revenue. Our methodology highlighted our intention to set a series of price caps. We explained that a price cap would largely insulate customers from the impact of changes in the customer base or volumes of consumption during a regulatory period.

Scottish Water expressed concern that this approach added complexity and increased risk and uncertainty. It asserted that it could be better to set one overall allowed price increase and to give indicative increases for different customer groups.

It is important that customers are able to understand the implications of the determination of charges on their bills. The Ministerial Guidance also asked us to ensure that cross-subsidy of £44 million was unwound equally, as far as possible, in favour of all non-domestic customer groups. These two factors require us to set and monitor a number of price caps. Most respondents, other than Scottish Water, were generally supportive of the move to a price cap regime. We have therefore decided to set price caps at the Strategic Review.

We have, however, noted concerns from stakeholders about the complexity of the price setting system and will review the approach further. We will publish more detailed information about tariff baskets in the draft determination and will use this as an opportunity to explain more fully the price caps that we intend to introduce.

Regulatory accounts and accounting separation

The Water Industry (Scotland) Act 2002 limits the remit of this Office to promoting the interests of customers of the core business. This will require us to be able to distinguish between Scottish Water's core and non-core functions. It is for Scottish Water and the Scottish Executive to determine whether Scottish Water conducts non-core activities. We have no role in this. No costs or revenue of non-core activities (except for the retail subsidiary of Scottish Water) will be included in the draft determination. The introduction of regulatory accounts will ensure that we are assessing the lowest reasonable cost of the activities required to deliver the Ministers' objectives.

Scottish Water's statutory accounts are not sufficient to provide the information we now require. Statutory accounts allow a greater degree of flexibility in the choice of accounting policies than do regulatory accounts.

Our methodology consultation explained that we proposed to adopt the practice of other regulators by asking Scottish Water to complete regulatory accounts. Regulatory accounts facilitate benchmarking both between companies and over time. They are therefore important to effective regulation.

Most respondents were generally supportive of the proposed approach. However, one respondent suggested that it would be simpler to prevent Scottish Water from undertaking non-core activities. As explained above, although we can see merit in some of the arguments against Scottish Water conducting non-core activities, we would still require regulatory accounts.

Financial modelling

We have built a financial model so that we can calculate the revenue that Scottish Water requires to carry out its core functions. In the methodology consultation we outlined the financial assumptions contained in the model.

It was suggested by one respondent that we should not assume that the infrastructure renewals charge is equal to the infrastructure renewals expenditure over the 2006-10 period. We reviewed that assumption and allowed Scottish Water in its second draft business plan the opportunity to vary its infrastructure renewals charge and expenditure over the regulatory control period.

In its response to the methodology consultation, Scottish Water also told us that it will need to pay corporation tax in the regulatory period 2006-10. This differs from the information it had supplied to us previously. We have reviewed the impact of this on our financial model. We are minded to take a conservative approach when assessing Scottish Water's likely tax liability. We are also considering our approach if we allow a tax allowance that is in excess of that which Scottish Water is required to pay. As with any cost, Scottish Water will need to manage its tax liability efficiently, including taking advantage of any tax shields.

Some respondents asserted that, rather than using the consumer price index (CPI) to measure inflation, we should use the retail price index (RPI). The argument for using RPI is that this is the index which Ofwat and other regulators use. One respondent believed that all regulators should change inflation indexes at the same time. Having reviewed the arguments, we continue to believe that CPI is the most appropriate measure of inflation to use with regard to year-on-year increases in operating costs. However, we recognise that there is value in ensuring that price caps are presented consistently between regulators. We are minded to set our price caps relative to RPI. It is also relevant to note that prices ought to be linked to RPI, since the real interest rate (and HM Treasury lending rates) are linked to index linked gilts. Index linked gilts pay interest, which is a function of the retail price index. It is likely that inflation variances would be addressed in the logging up/down process prior to the *Strategic Review of Charges 2010-14*.

In our methodology we proposed to use the Ofwat ratios as the primary indicator of financial sustainability. On balance, respondents agreed with the use of these ratios. One respondent suggested that we should analyse a set of financial ratios relating to how potential investors would regard Scottish Water.

We agree in principle that Scottish Water should be assessed using ratios that are specific to its circumstances. However, we still consider that the Ofwat ratios have clear benefits. Ofwat consulted extensively with the financial markets in developing these ratios. It used compliance with these ratios as a guide to whether the companies south of the border were likely to be able to maintain at least 'investment grade' credit ratings. Such financial strength would be prudent in a public sector organisation where debt is provided by Ministers. Moreover, one of the reasons to adopt the RCV approach is because it allows us to compare financial ratios with those of the companies south of the border on a consistent basis. We are minded to set Scottish Water's required level of revenue at a level in 2009-10 which would ensure that Scottish Water complies with the Ofwat ratios – assuming that it meets the full terms of its regulatory contract.

Establishing an initial RCV

In the methodology consultation, we explained that most UK regulators use a market value approach to set the initial RCV of the businesses they regulate. This approach is clearly not possible for a public corporation such as Scottish Water. In March 2005 we wrote[2] to Scottish Water stating that the initial RCV would be in the range of £3.3 billion to £3.8 billion.

We outlined the three alternative methods that are available to us to set a robust initial RCV for Scottish Water. These are an asset value approach, a comparator approach and a discounted cash flow approach. Each of these approaches is mutually exclusive.

A range of views were expressed about which method is most reliable for setting the initial RCV.

One respondent observed that it may be better to use each of the methods to derive different values for the RCV and to analyse the sensitivity around each number. This respondent also suggested that we should set the initial RCV at a level that is consistent with Scottish Water's financial sustainability. We believe that, given the uncertainty and range of views surrounding the establishment of an RCV, this is a sensible approach. We are examining the most effective way to achieve this.

Stakeholders generally supported the use of the comparator method. We are minded to use this

[2] This letter is available on our website – www.watercommissioner.co.uk

approach either in setting the initial RCV or in checking that the initial RCV is set at an appropriate level. Our approach will have to ensure that the initial RCV will allow Scottish Water to meet the targeted financial ratios. We will also ensure that the RCV calculation is fully transparent and stated clearly within our Strategic Review of Charges, so that stakeholders can understand how the initial value was calculated.

The allowed rate of return

The allowed rate of return is the rate of return that we believe Scottish Water requires in order to meet the objectives that have been set by Scottish Ministers. This rate of return must be set at a level such that Scottish Water can finance its efficient operation.

In our methodology consultation we described four possible approaches to setting an appropriate rate of return for Scottish Water:

- adopt the Ofwat allowed cost of capital;
- use long-term average real borrowing rates;
- use the discount rate suggested in HM Treasury's Green Book; and
- use a hybrid approach.

Our current thinking is as follows. In the private sector, a regulator sets an allowed rate of return. This is often referred to as the cost of capital. The regulator will set this rate of return to reflect current and expected market conditions. The regulator has a duty to set an appropriate rate of return (a weighted average cost of capital (WACC)) such that an efficient company can properly finance its functions. A company may choose a mix of debt and equity funding but the cash rate of return on its regulatory capital is capped (unless it out-performs efficiency targets).

In the public sector, the regulator cannot set the rate of return based on his observation of the cost of capital in the market. Scottish Water's cost of debt is set by Government. The debt supply curve is determined by the Public Expenditure Levels set by Ministers.

It is therefore not possible to estimate a market-based WACC for Scottish Water. As a public sector organisation it does not have contributed equity capital, although it generates and reinvests trading surpluses. Scottish Water does not currently pay dividends and therefore all of the surplus generated can be reinvested for the benefit of current and future customers. These retained earnings differ from retained earnings in the private sector in that they are not reinvested with the specific goal of generating increased surpluses in the future.

Respondents expressed a range of opinions about each of the four options. Some agreed with our view that it would be inappropriate to allow Scottish Water the same rate of return that companies have been allowed in the private sector. Others suggested that when we set the allowed rate of return we should be looking to estimate the cost of capital that private markets would require.

We are minded to set an allowed rate of return such that Scottish Water is able to finance its operations.

One respondent suggested that there is greater risk in Scotland because of greater regulatory risk. They argued that Scottish Water should have a greater allowed rate of return to compensate for this risk. We are not yet persuaded that regulatory risk is any greater in Scotland than it is in England and Wales.

We are minded to apply a modified version of the private sector WACC approach. We would combine the observed real cost of public sector debt with an estimate of an appropriate rate of return on the customer retained earnings (the equity portion of Scottish Water's RCV) in order to produce an allowed rate of return.

In this approach, since we are considering setting 2009-10 revenue at a level consistent with that required for compliance with the financial ratios, the actual rate of return would be superseded by a revenue adjustment or by a lower RCV. Prices to customers would be unaffected.

In our methodology consultation we asserted that we would make an allowance for embedded debt for this regulatory control period, but would only make such allowances in future if there had been a material change in the rate of inflation.

Two respondents did not agree with this approach. One argued that if we set the allowed rate of return at the market cost of capital then we would not need to fund embedded debt. Another argued that we had not properly explained why no embedded debt allowance would be made beyond 2010 and that we had not properly defined what a material change in the rate of inflation would amount to.

We are minded to allow the costs of embedded debt for this regulatory control period. This allows us to estimate the current cost of capital to Scottish Water and it means that we do not have to deal with issues relating to the appropriate average real interest rate.

Regulatory capital value – treatment of depreciation and additions

In Chapter 10 of our methodology consultation we discussed how the value of the RCV changes over time and how the method we use to take account of these changes can influence the prices that customers pay. The chapter provided further background information about using the RCV method of price setting. We did not ask any specific questions for consultation in this chapter, although we did welcome stakeholders' views on the issues raised.

Respondents stressed the importance of ensuring that Scottish Water is incentivised to be efficient and effective in its capital investment programme. As part of this, respondents argued, it is important to make sure that there is no misuse of additions to the RCV.

Interim determinations and logging up and down

Interim determinations and the logging up and down process are the two mechanisms which Ofwat currently uses to adjust the regulatory price settlement in the event that assumptions made at the price review need to be revised. Our methodology consultation explained that the imminent change in the regulatory framework to create a Water Industry Commission with a power to determine prices will make it necessary to introduce a similar framework in Scotland. This would ensure that Scottish Water is able to recover the costs of any unexpected expenditure that results from uncertainty rather than underperformance.

Two respondents suggested that we should not introduce a process of interim determinations because Scottish Water should have to plan to work within its budget and manage its risks appropriately.

Two respondents felt that Ofwat's logging up and down process is flawed and that we should expand it so that it is more comprehensive, transparent and predictable. In particular, Scottish Water suggested that we should ensure that the process is more formal, with an annual statement setting out which items can be logged up and down.

One respondent argued that an interim determination of price limits should be triggered by any new or revised environmental requirements. Another argued that we should adopt the same procedures as in England and Wales, but should expand the number and type of triggers for an interim determination.

Our methodology consultation asked about the 'relevant changes of circumstance'. One respondent highlighted that the move to a different regulatory system could be considered a relevant change in circumstance for an interim determination.

We also asked for views about the most effective way to consult with customers about a potential price change. Suggestions included customer research, both quantitative and qualitative, and consulting with consumer groups and similar organisations.

One of the consultation questions asked whether customers would prefer prices to be revised downwards during a regulatory period (for example in the event of slow delivery of outputs), even if prices were likely to go up by a greater percentage in future as a result. One respondent suggested that customers generally prefer stable prices, so downwards adjustments followed by more rapid rises may not be what customers want.

In an open letter to the Minister for Environment and Rural Affairs (a copy of which is available on our website), we asked for guidance on the extent to which price limits should change during a review period. The Minister provided this guidance in his February policy statement on the principles of charging. In this Guidance, the Minister indicated that the new Commission should seek to establish charge limits that deliver the most regular and smooth charges profile possible in the circumstances. In particular, the Commission should avoid reductions in charges one year if such a reduction could not be sustained, or if they would need to be followed in subsequent years by an increase in real terms.

We agree with stakeholders that adjustments made at the end of a regulatory control period to reflect the outcomes in the previous period should be transparent. We also agree that they should be proportionate and, if possible, predictable. We need to ensure that incentives are created which will encourage efficiency in the long-term management of the industry. We are also considering the implications of Scottish Water's request for an annual statement on items to be logged up and down.

We are minded to adopt the same rules as Ofwat for interim determinations and logging up/down.

Setting price caps: the role of the tariff basket

Our methodology consultation explained that we proposed to establish tariff baskets to cover the principal services provided by Scottish Water. This, we explained, would help to ensure that the process of unwinding cross subsidies would be as transparent as possible. It would also allow customers to see more clearly the likely impact of the Strategic Review on their bills.

While some respondents agreed with our approach to tariff baskets, several respondents expressed concern about the complexity of the tariff basket system.

One respondent argued that using tariff baskets would result in a shift away from the business rates model. The view was also expressed that as water is a public service it should be funded from general taxation. This is a matter for public policy and is not within our remit.

Tariff baskets are about measuring (and limiting) price increases in a consistent way. However, as stakeholders are clearly concerned about the complexity of tariff baskets we will continue to review their use. We intend to publish full details of the tariff baskets in the draft determination.

Respondents generally agreed with our proposal to introduce at least eight tariff baskets (which is more than is currently used by Ofwat in England and Wales). However, some respondents, including Scottish Water, asserted that this would create additional complexity and reduce Scottish Water's flexibility to deal with particular customers.

Most respondents agreed that we should introduce additional tariff baskets for water and waste water customers with standard metered connections. However, Scottish Water again argued that this would be more complex and less flexible.

We will continue to review our proposals for tariff baskets in light of the responses we received. Our initial view is that we should introduce the additional tariff basket for measured customers with a standard connection.

Our methodology consultation explained how we proposed to calculate the weighted average price increase. Most respondents agreed with the proposals. The point was raised about the need to phase in any changes in charges. We agree that, where possible, phasing of changes in tariffs is an important element of a charging policy. The phasing of charges is, however, a matter for public policy and was decided by the Scottish Executive in guidance given to this Office and Scottish Water in February 2005.

We asked for respondents' views about whether or not a target date of the end of December 2005 would be acceptable to announce tariffs, given that details about tariff baskets and their weightings would be included in our draft determination and the final determination prepared by the new Commission. Respondents agreed with this proposal.

Standard customers

Our methodology consultation explained that we proposed to develop our use of standard customers to help customers to understand the likely impact of the Strategic Review on the bill they pay.

Respondents generally welcomed the increase in the number of standard customers and the additional transparency this creates.

We proposed a number of additions and changes to the standard customers, and sought views about whether or not we had achieved broad representation of customer types. Scottish Water gave a detailed response in this regard. We have reviewed its suggestions and agree with most of the changes it proposed. The full list of the revised standard customers is detailed in Table 1.

Table 1: Revised list of standard customers

Name in 2002-06 Review	Proposed name for 2006-10 Review	Water		Sewerage		
		Meters (no x size (mm))	Volume (m^3)	Meters (no x size (mm))	Volume (m^3)	RV
Newsagent	Convenience store	1 x 20	30	1 x 20	28.5	£5,000
Garage	Garage	1 x 20	100	1 x 20	95	£10,000
Restaurant	Large restaurant	1 x 20	500	1 x 20	475	£100,000
Commercial	Large office	1 x 25	900	1 x 25	855	£750,000
Retail	Retail group	2 x 20 20 x 25 1 x 35	4,500	2 x 20 20 x 25 1 x 35	4,275	£1,700,000
Food manufacturer 1	Food manufacturer 1	2 x 25 1 x 80	50,000	2 x 25 1 x 80	47,500	£100,000
Food manufacturer 2	Food manufacturer 2	2 x 25 1 x 50 1 x 100	100,000	2 x 25 1 x 50 1 x 100	95,000	£260,000
Manufacturing	Large manufacturer	1 x 150	175,000	1 x 150	166,250	£1,225,000
Brewers	Brewers	2 x 25 1 x 100 1 x 150	600,000	2 x 25 1 x 100 1 x 150	150,000	£500,000

As a result of representations from Scottish Water we have removed the 'pharmaceuticals' tag from the large manufacturer, as Scottish Water has advised us that the characteristics are not typical of a pharmaceuticals company. We have also changed the description of the newsagent to that of a convenience store, as Scottish Water felt this would be more descriptive.

Scottish Water asserted that it is difficult to state what a typical rateable value is. While this is true, we believe that the rates we have chosen are representative of the customer base and that they can be used to illustrate changes in tariffs.

Table 2: Standard trade effluent customers

Name	Volume		Load		Average strengths	
	Annual (m^3)	Daily (m^3)	Total suspended solids (kg/day)	Biological oxygen demand (kg/day)	Total suspended solids (mg/l)	Settled chemical oxygen demand (mg/l)
Bakery	200	0.55	0.5	0.75	575	1,600
Clothing manufacturer	12,000	32.9	1	1	20	300
Abattoir	90,000	246.6	150	250	600	1,500
Electronics business	550,000	1,507	15	50	10	75
Printers	10,000	27.4	5	40	100	2,500
Distillery	150,000	411.0	7	55	15	200

Scottish Water suggested that churches and hospitals should be represented within our standard customers. It was not our intention to include every type of business organisation in Scotland, but to try to achieve representative customer characteristics. We believe that the customer characteristics we have chosen will allow us to demonstrate the incidence effects of changing tariffs.

Method for setting retail and wholesale prices

The proposed competition framework will allow new entrants to obtain a licence to provide retail services to non-domestic customers. These new entrants would be retail specialists who would buy water and sewerage services wholesale from Scottish Water. To determine appropriate wholesale prices, we first need to define the wholesale and retail activities. Our methodology consultation set out the criteria we propose to use in assessing different approaches to setting wholesale prices. It also outlined accounting cost and comparator approaches for setting wholesale prices.

Respondents agreed with our criteria for assessing approaches to determining the wholesale charge. We received a range of opinions about how wholesale charges should be set.

One respondent felt that the accounting approach was the best way to achieve the right balance between providing incentives to enter the market and achieving the required revenue for Scottish Water wholesale. Another argued that the market should be left to decide the wholesale price, as any attempt to estimate the market price would be invalid because it could only be decided by supply and demand.

Two respondents argued that the efficient component-pricing rule should be used to set the wholesale price. These respondents argued that it is similar to the approach adopted by Ofwat in England and Wales for competition for large customers. Additionally, respondents warned against the accounting approach as it could overstate the retail component, leaving the wholesaler with too little revenue and damaging the viability of the industry.

We have reviewed the responses received from stakeholders but are not yet persuaded of the validity of these arguments. On balance we are minded to use the accounting approach to set wholesale charges. While we note stakeholders' concerns about this approach, these concerns only remain valid if the accounting separation is in some way incorrect. We have already described our approach to the split between retail and wholesale activities, and expect that our analysis of this information will determine an appropriate split.

Most respondents agreed that the split between wholesale and retail activities should be a notified item[3], as we had proposed. However, one respondent was concerned that the retail/wholesale split would not pass the triviality threshold for an interim determination. If it is trivial, then an interim determination would not be required.

It would be desirable to reach agreement with all parties about the activities that comprise the retail and wholesale businesses. However, our view is that the future licensing regime that will be introduced under the Water Services etc (Scotland) Act 2005 will formalise the process of reviewing the retail activities.

Connection charging regime

Our methodology consultation asked whether there were any lessons to be learned from experience in England and Wales in relation to the connection charging regime.

One respondent supported a move to a connection charging regime. Another highlighted the need for change away from the current situation, as Scottish Water is seen as a barrier/constraint to new development. A third respondent saw no reason why connection charges in Scotland should be any different from the situation in England and Wales.

The Scottish Executive will announce its decision on connection charging in light of its 'Paying for water services 2006-10' consultation. We will incorporate this decision into the price limits we set.

[3] A 'notified item' is an area of uncertainty in the determination. If there is a substantial variance, either the regulator or the regulated company may seek an interim determination.

Chapter 4
Price cap regulation and the scope for operating cost efficiency

Introduction

In Volume 4 of our methodology consultation we described how we propose to assess operating expenditure efficiency. So that stakeholders could understand the models and processes we use, the consultation described:

- how the regulatory regime can create incentives to improve performance;
- how we propose to decide on the level of operating costs that Scottish Water should be allowed to incur; and
- how best to ensure that customers receive an appropriate level of service.

Types of regulatory framework

In our methodology consultation, we described the different types of incentive-based regulation that can be used to drive companies to achieve cost efficiencies. We provided information about the five regulatory models and explained that price cap regulation based on the RPI-X approach is the mechanism favoured by utility regulators in the UK. This has already proved very successful in encouraging utilities to pursue continuous efficiency enhancement and keep prices down.

We set out our intention to use the RPI-X framework at the *Strategic Review of Charges 2006-10*. Responses to the consultation confirmed stakeholders' views that this was the right approach.

RPI-X incentive framework and benefit sharing

Our consultation went on to consider how incentives work and the difference between incentives in the public and private sectors. We then examined in some detail the effectiveness of the RPI-X approach as an incentive framework in regulating the Scottish water industry.

Water companies have continuing large investment programmes. The incentive to improve the efficiency of capital investment is as important as reducing operating costs. RPI-X creates an incentive to improve the efficiency of capital investment by allowing an increased cash return on the RCV.

We highlighted a potential problem when calculating the cash return on the RCV, in that it could provide an incentive for the regulated organisation to invest inefficiently. In its 1999 price review, Ofwat responded to this issue by placing a cap on the capital expenditure that could be included in the RCV during the regulatory control period.

There is a risk, however, that a cap could cause companies to defer essential capital investment, which could put customer service levels at risk. Ofwat has proposed that the amount of capital expenditure that can be excluded from the RCV should be capped at 10% of regulatory revenue. This is known as the 'service-capping rule'. Any over-investment beyond the 10% threshold would earn the normal rate of return.

We asked stakeholders if they considered that a cap would be required on the capital expenditure to be included in the RCV for Scottish Water. We also sought their views about whether we should introduce an equivalent service-capping rule for Scotland.

Most respondents were not in favour of a capping rule. One argued that creating a distortion in order to fix a separate distortion felt intuitively wrong. Another said that the 10% materiality threshold created an asymmetrical incentive, with benefits for 'under-spend' being passed to customers but benefits for 'over-spend' only being added beyond a threshold.

There was a suggestion that the service-capping rule would mitigate the risk of undertaking high levels of supplementary investment which are not then recognised by the regulator. We understand this concern and agree that it would be in the interests of all customers to minimise this risk – providing customers demand the investment and that it is undertaken efficiently.

Any service-capping rule needs to be considered alongside the logging up and down mechanisms. We plan to adopt the same rules for logging up/down as Ofwat. We believe that they are sufficiently robust to obviate the need for a service capping rule.

Our methodology consultation highlighted that for the incentive framework to be effective, the management of the regulated company must share in the benefits. In the public sector, this is best achieved by ensuring that the incentive mechanism is transparent, by setting objective targets and by aligning these targets with the overall interests of customers.

We asked for stakeholders' views about whether the RPI-X mechanism would provide appropriate incentives for Scottish Water. Respondents generally agreed that RPI-X created appropriate incentives, although suggested that these can be fairly limited. One respondent questioned whether out-performance in one period would lead to a reduction in the RCV in future years. This, they argued, would lower the allowed rate of return in future years, creating a disincentive to out-perform.

We asked whether there were any significant differences between private and public companies that had not been taken into account. One respondent said that in private companies there were both 'sticks' and 'carrots,' while in a traditional public sector model the existence of 'sticks' is limited. This assumes that senior managers in the public sector are less afraid of losing their jobs in the event of failure. This is essentially an issue for the Scottish Executive as the owner of Scottish Water. However, we believe that the greater transparency and more objective reporting of progress towards targets that we are introducing will increase the degree of 'sticks'.

Respondents generally agreed with our assessment of the importance of benefit sharing in providing incentives to Scottish Water to achieve efficiencies. One respondent, for example, observed that in a public sector model customers are shareholders too. They therefore have the right to expect to see the benefits of outperformance in lower charges. Customers can benefit from the incentives created and this should be rewarded, but only if performance is exceptional. We wrote an open letter to Scottish Ministers on this issue on 10 May 2005[4].

We asked for views about the level of transparency for senior management bonuses in the public sector model. Respondents felt that full transparency is desirable because in the public sector there is no commercial sensitivity surrounding managerial bonuses or company objectives.

Respondents also agreed with our proposals that managerial bonuses for Scottish Water should be aligned with independently assessed regulatory and customer service targets[5].

In its response, Scottish Water agreed with the principles laid out in the methodology. We recognise and welcome Scottish Water's commitment to greater transparency in relation to managerial bonuses.

Following publication of our draft determination, we will ask Scottish Water for details of its management bonus scheme and will publish the response. This should ensure that the incentive scheme is fully transparent. We have written to Scottish Water seeking its views on our second open letter.

Establishing a baseline for operating costs

The baseline level of operating expenditure is the expenditure incurred in the base year. The methodology consultation explained that we need to establish a baseline for Scottish Water's operating expenditure for the Strategic Review of Charges. This baseline is used to set efficiency targets.

There is one base year for each regulatory control period. Setting a baseline is not a straightforward process. Our methodology consultation set out the options for determining the base year and explained that

[4] Attached as Appendix 3.
[5] These are targets set by the Scottish Environment Protection Agency, the Drinking Water Quality Regulator and this Office.

we proposed to use 2003-04 as the baseline for operating expenditure and 2004-05 as the base year for the final determinations. We considered that this would lead to a simpler, more transparent monitoring process. Respondents agreed with this proposal.

We also set out how we would make adjustments to base operating costs to ensure that operating costs are measured in a way that is consistent with the way in which targets were set at the *Strategic Review of Charges 2002-06*.

Scottish Water asked for the opportunity to discuss these adjustments with us before we publish the draft determination. If Scottish Water provides additional information once it has had the opportunity to consider our draft determination then we would expect the new Commission to take this into account. Although we consider that Scottish Water should have made its case through its business plans, we will endeavour to consider any information they provide.

As the final year of the current regulatory control period is 2005-06 it will be necessary for us to project Scottish Water's operating expenditure in that year. The methodology consultation outlined five options for doing this, and asked for respondents' views on the options and on the impact that different assumptions might have.

We received responses which favoured both option 1 (which assumed flat real operating expenditure in 2004-05 and 2005-06) and option 5 (using the forecast operating expenditure which Scottish Water submitted in its second draft business plan in April 2005).

Scottish Water expects to make significant progress on operating expenditure in 2004-05 and 2005-06.

One respondent said that by using a baseline of 2003-04 and 2004-05 to calculate efficiency targets then applying these efficiency targets to 2005-06 operating costs, we would overstate the efficiency gap, especially when a company was closing the gap on the frontier company. We agree that where a company is closing the efficiency gap, it could be inconsistent to apply a target calculated on historic inefficient performance to an expected future (efficient) performance.

However, we are minded to calculate the efficiency gap and target allowable operating expenditure for 2006-10 using reported information for 2003-04 (draft determinations) then 2004-05 (final determinations). We propose to ensure that the profile of our targets for 2006-10 is achievable from Scottish Water's expected performance in 2005-06.

Our methodology consultation explained that we need to consider the potential changes in baseline operating expenditure, outside the control of management, which could occur during the regulatory control period. We gave three examples of such changes, namely pension costs, rateable values and energy costs. We also asked stakeholders' views about any other factors that could result in changes in baseline operating expenditure in 2006-10.

One of the respondents put forward particular concerns about the factors we had identified in the consultation. Another suggested that we should extend our list of factors to include running costs of the retail business and 'others'.

We set out a number of criteria for assessing Scottish Water's claims for changes in baseline operating expenditure and respondents agreed that these were suitable.

One respondent raised concerns about the transparency of adjusting base operating expenditure claims for inflation. We will ensure that any adjustments made to claims for increases in base operating expenditure are fully explained in the draft determination.

Ensuring like-for-like comparisons of efficiency

Our methodology described our approach to comparing Scottish Water's performance with that of other water and sewerage undertakers, and explained the steps we take to ensure that our assessment of Scottish Water's efficiency is fair, accurate and is made on a like-for-like basis.

We explained that we use benchmarking techniques to assess Scottish Water's relative efficiency and that essentially these techniques involve comparisons of Scottish Water's performance with that of the companies in England and Wales.

The approach we have chosen to employ is a 'top down' approach; in other words, our comparisons with the water and sewerage companies in England and Wales remain at a relatively high level. Most respondents agreed that this approach is the most appropriate way to compare Scottish Water's performance with that of the companies south of the border.

Ofwat's approach to assessing operating cost efficiency

Our methodology consultation explained that we proposed to extend the Ofwat econometric models for operating expenditure to Scotland as we believe these models are robust and can be applied to Scottish Water. Stakeholders generally agreed with this; one respondent asserted that the ten companies in England and Wales represent a "very reliable pool of industry performance data". However, the responses we received did highlight some concerns about Ofwat's approach.

For example, one respondent noted that only six of the nine Ofwat models were 'econometric' in the usual sense of the word, and that the explanatory power of the models was low. Other respondents argued that we should make a greater adjustment for errors in modelling. This is based on a report which suggests that only around half of the residual calculated by Ofwat's models could be attributed to inefficiency. We will review and, where appropriate, incorporate the evidence into our approach. However, we note that the Ofwat models have been extensively reviewed by the Competition Commission and found to be reliable.

An alternative way to assess operating cost efficiency

At the time of the last Strategic Review, we developed an alternative model to assess Scottish Water's efficiency. This was in addition to our use of the Ofwat models. We wanted to ensure that we were using two independent, robust approaches and that our targets were objective and properly justified. The alternative model was used to check the results of the Ofwat econometric models.

In our methodology consultation, we explained that we proposed to develop a revised version of the alternative model, which would include Scottish Water within the 'standard' unit cost calculations. We sought stakeholders' views about the alternative model and about our plans to develop it further.

Two respondents supported the development of an alternative model. One respondent raised concerns about our approach, claiming that our model is a unit cost model and, as such, is not robust. Respondents also observed that the alternative model incorporates economies of scale whereas the Ofwat econometric models generally do not.

We are not yet persuaded by this line of argument. Most of Ofwat's econometric models incorporate economies of scale, either at plant level (size of treatment works) or overall.

Our methodology consultation went on to ask stakeholders if they could suggest other approaches to assessing the scope for operating efficiency. One respondent suggested that a simple way to assess efficiency would be to look at the efficiency achievements made by the water and sewerage companies in England and Wales in the years following privatisation. We agree that these efficiency savings (provided they have been appropriately calculated) should inform our targets, because they demonstrate the rate of progress that can be achieved.

Another suggestion was to use panel data (which involves taking information over more than one year) to assess relative efficiency. We are currently reviewing this suggestion and will include our conclusions in the draft determination.

Ensuring that modelled results are objective and fair

Our models cannot take account of all of the factors that influence costs. Some of these factors (those that are endogenous, that is, within the control of management) should be excluded from the model. Others, which may relate to the operating environment or the level of service, may increase or decrease the level of cost.

We asked stakeholders if they agreed that we should take differences in the scope of activities and the level of service provided into account when determining Scottish Water's operating efficiency relative to that of the companies south of the border. We also asked which differences stakeholders thought should be recognised.

Respondents generally agreed that we should take account of differences in scope and in the level of service when assessing operating expenditure efficiency.

One respondent, while endorsing this general principle, argued that these differences could only be quantified in a way that increases – not decreases – costs. They argued that Ofwat does not take account of negative special factors. We consider that it is only logical, and in customers' interests, to take account of factors that increase or decrease costs.

It is not a simple process to assess the cost of any such differences. Our methodology consultation set out a range of possible approaches. One respondent agreed with two of the options: using information from the companies south of the border to place a monetary value on differences in the scope of activities and levels of service; and asking Scottish Water to estimate the additional cost of providing both the equivalent scope of activities and level of service to England and Wales.

We are minded to use:

- information from the companies in England and Wales to assess the costs of additional scope (as Scottish Water would not require this information to plan); and

- information from Scottish Water (as far as possible) to assess the costs of additional levels of service, since Scottish Water needs to understand and plan this.

The scope and timeframe for improvement

Our methodology consultation explained our approach to assessing the scope for Scottish Water to improve its performance. We set out the approach in terms of six main strands of analysis. We received a number of responses relating to this issue.

One respondent agreed with our approach. Another explained that their own analysis of the rate of catch-up shows that there is no relationship between the initial level of efficiency and the rate of catch-up. We believe that this difference stems from the fact that our analysis relies on efficiency scores rather than efficiency bandings.

A respondent felt that we should not base our assessment on the best five years' performance in England and Wales as this could overstate potential efficiency savings. We are continuing to review evidence on this issue but would tend to believe that if a significant and demonstrable efficiency gap exists, it is in customers' interests to assess the pace of improvement that has been shown to be achievable.

New operating expenditure

Scottish Water could incur significant new operating costs in the next regulatory control period. It is important for us to scrutinise carefully any claims for such new operating costs to be included in price limits.

Our methodology consultation explained that we propose to continue to place the onus on Scottish Water to identify and justify new operating expenditure. It also stated that we planned to use the same criteria as at the last Strategic Review in assessing new operating expenditure.

Respondents generally agreed that these criteria continue to be appropriate for the 2006-10 review. Scottish Water, however, did not agree with the criteria.

The methodology consultation explained that we share Ofwat's view that it is easier to deliver efficiency savings in new operating expenditure than in baseline operating expenditure. We said that we were likely to set higher efficiency targets (in percentage terms) for new operating expenditure than for baseline operating expenditure. We sought stakeholders' views on this point.

One respondent agreed that in general the scope for efficiency on new operating expenditure would be greater. However, they questioned whether, given Scottish Water's current inefficiency, there would not be greater scope to reduce base operating costs. While we agree that there will be scope for Scottish Water to reduce its base operating costs, we are continuing to assess the relative scope for efficiency in both new and base operating costs.

Another stakeholder argued that there is little regulatory precedent for setting higher efficiency targets on new operating expenditure relative to base operating expenditure. However, this is the approach that Ofwat has taken at each of its price reviews and we are minded to adopt the position we set out in the draft methodology.

Public Private Partnership financing

The nine PPP contracts represent capital investment on behalf of customers of around £550 million. These contracts appear to have represented good value for money at the time they were concluded. However, improvements in Scottish Water's performance have made it less clear that the PPP contracts represent good value for money to customers today.

Our methodology consultation highlighted the options that could be taken to reduce PPP costs. This included setting an efficiency target for PPP or adjusting the level of allowed revenue to reflect the efficient costs (financing and operating) of the services that are being delivered through PPP.

We suggested that if we found that customers were paying too much for the services provided (or would be by the end of the next regulatory control period), we would take account of this in Scottish Water's price caps.

We received several responses on the best approach to PPP contracts, offering a number of different views.

One respondent considered that setting an efficiency target for PPP contracts would be an excellent initiative. Several respondents, on the other hand, argued against setting efficiency targets for PPP contracts. Although we do not necessarily agree with each of the arguments that were put forward, we have decided on balance that it is best not to pursue the proposal. One stakeholder suggested that we should not allow our criticisms of past PPP agreements to restrict the opportunity for Scottish Water to use this method of investment and service delivery if it represents best value for customers.

We still expect Scottish Water to manage these contracts to ensure that customers pay the minimum for their waste water service, including taking any opportunities available to renegotiate these contracts on more beneficial terms.

Setting the allowed level of operating costs

We propose to set targets for Scottish Water in terms of the total allowable operating expenditure (not including depreciation). We are keen to ensure that our targets are clear and unambiguous. We plan to set the total allowable operating expenditure at a level which we believe is sufficient for Scottish Water to carry out its operations for each year of the regulatory period. This is the amount that will be funded through charges to customers.

Our methodology consultation set out a detailed, eight-step process for calculating allowable operating expenditure. We received a number of responses in relation to our proposed approach.

One respondent said that it is important to distinguish between the scope for efficiency improvements and the target for allowable operating costs. Another agreed with our proposal to set allowable levels of operating expenditure for the wholesale water, wholesale sewerage and non-domestic retail components of Scottish Water. A third respondent welcomed the eight-step process as logical, clear and persuasive.

In response to our question about the scope for improved efficiency by Scottish Water, a respondent highlighted that the rate of improvement could be expected to be at least as high as that achieved by the companies in England and Wales over the last regulatory period. The respondent did not consider that Scottish Water's performance to date was necessarily a good guide.

We also asked if respondents had any views about Scottish Water's performance beyond 2010. A stakeholder suggested that franchise regulation may be more appropriate from that time. We are content that the regulatory framework, especially as it is being strengthened, should deliver significant benefits for customers. However, decisions concerning the model for service delivery are a matter for the Scottish Executive.

Regulating levels of service

Our methodology consultation explained that we have to determine how to ensure that an appropriate level of service is delivered at the same time as cost efficiencies are being achieved. We outlined two possible approaches:

- benchmarking Scottish Water's performance; and
- target setting for some or all aspects of service quality.

Our methodology consultation outlined the strengths and weaknesses of both approaches. We proposed to retain the benchmarking approach as it is tried and tested. However, we also consider that there may be a case for setting targets for certain key areas of service, such as leakage, if there is sufficient information to do so. We sought responses on both approaches.

One respondent supported both approaches. Another was of the view that target setting could require too much information and could breach the principles of transparency and proportionality. A third respondent agreed that each approach may be appropriate in different circumstances.

One respondent observed that adjusting the benchmarking approach so that new operating costs directed at improving levels of service are allowable fits the current circumstances of the water industry in Scotland well.

Another stated that the special factors that are relevant for assessing the efficiency gap are also relevant for assessing the service quality gap. We note that Ofwat does not consider company-specific factors when comparing levels of service.

We sought stakeholders' views about whether there are any targets that are appropriate in pursuing the benchmarking approach. Two respondents argued that it was inappropriate to set a target for leakage. Rather, the price cap mechanism should be used to provide an incentive for Scottish Water to achieve the economic level of leakage.

We are minded to set the allowed level of operating costs such that Scottish Water should deliver a level of service that is broadly equivalent to that provided by the companies south of the border. We are currently considering the use of milestones for customer service to monitor performance.

Monitoring operating expenditure and levels of service

It is our role to monitor progress against targets and to verify that service levels to customers do not suffer as a result of management action to reduce costs. The methodology consultation outlined the mechanisms and tools that we propose to use for this, and we sought responses on these proposals.

One respondent welcomed the appointment of a Reporter and the introduction of regulatory accounts in Scotland. They raised concerns about the size of adjustments to operating expenditure for monitoring purposes. Although we will continue to make adjustments so that we can make consistent and meaningful comparisons, we believe that regulatory accounts should reduce the need for such adjustments.

One respondent suggested a number of features that should be included within a framework for monitoring levels of service. Another suggested that the combination of monitoring Scottish Water's levels of service and its expenditure should ensure that customers are being well protected.

We are minded to continue to monitor carefully both the level of service provided and the level of cost incurred. In this regard, we continue to believe that if we need to make adjustments to ensure like-for-like comparison, it is in customers' interests that we do this.

Chapter 5
The scope for capital investment efficiency

Introduction

Volume 5 of our methodology consultation described how we proposed to set the level of expenditure for Scottish Water to meet the investment priorities outlined in the Ministers' guidance at the *Strategic Review of Charges 2006-10*.

The methodology consultation explained in detail our proposed approach to assessing the scope for capital expenditure efficiency. In particular, it:

- provided an introduction to the components of capital investment in Scotland and explained the Quality and Standards investment programme;
- discussed the issues that need to be addressed in order to establish a robust baseline for the investment programme; and
- outlined how we proposed to compare Scottish Water's relative capital expenditure efficiency with that of the companies south of the border.

The Scottish Executive's consultation: 'Investing in water services 2006-14'

Scottish Ministers are responsible for defining investment priorities for the water industry in Scotland. The Quality and Standards process identifies the priorities of customers, the quality regulators and other stakeholders. Ministers also sought views on these issues in its consultation, 'Investing in water services 2006-14'.

Our methodology consultation explained that one of the disappointments of *Quality and Standards II* has been the difficulties faced by both stakeholders and customers in monitoring Scottish Water's delivery of the investment programme. Scottish Water's process of trying to clarify a detailed baseline of outputs took far longer than it should have done.

We do now have what we believe is a broadly complete list of all of the projects to be delivered in *Quality and Standards II*. In preparing for the next regulatory control period, lessons must be learned from the experience with *Quality and Standards II*. In other words, there is a clear need for a detailed definition of the baseline capital programme. This should determine the investment priorities for the period 2006-14.

Our methodology consultation outlined the issues raised in the Scottish Executive's consultation, 'Investing in water services 2006-14', and summarised our response. Our main concerns are that the investment programme should be properly defined, that the inputs and outputs should be measurable, and that the investment programme is placed in the public domain.

We believe that these steps are necessary to ensure that:

- stakeholders have a common understanding of what is included in the investment programme;
- customers' expectations can be met; and
- delivery of the *Quality and Standards III* investment programme can be monitored effectively.

Our methodology consultation proposed that the investment programme should be defined in detail at an asset level, and that it should be placed in the public domain. The majority of respondents agreed that the final investment programme should be defined in detail at an asset level. One respondent questioned whether the entirety of the investment programme could be defined at this level of detail.

The majority of respondents agreed that this information should be available in the public domain. One respondent was concerned that publication of information could affect commercial negotiations for those contracts not yet agreed. While we recognise that publishing the list of projects may affect commercial negotiations, we believe that it is likely to be in customers' interests. We are therefore minded to publish this information, although we would take into account the commercial sensitivity of any relevant information.

Capital maintenance

Capital maintenance is important to the ongoing effective management of the assets. Replacing assets in a timely way is essential to maximising the cost effectiveness of the network's performance and maintaining the level of service to customers.

Our methodology consultation explained that in the 2006-10 review we propose to allow a level of capital maintenance expenditure that provides sufficient investment to maintain the asset base in the long term. This will ensure that present and future customers receive an acceptable level of service.

The UK Water Industry Research (UKWIR) common framework for capital maintenance provides a standard way to estimate the future requirement for capital maintenance to provide defined levels of service to customers and the environment. It emphasises the importance of using both levels of service indicators (such as drinking water quality) and asset performance indicators.

Our methodology consultation highlighted our support for the use of the common framework approach to capital maintenance. Throughout the *Quality and Standards III* process we have encouraged Scottish Water to adopt the framework's principles in developing its capital maintenance proposals. In the *Strategic Review of Charges 2006-10*, we will review Scottish Water's use of the common framework approach to establish its requirement for capital maintenance.

Our methodology consultation asked whether respondents agreed that the UKWIR common framework provides a suitable mechanism for establishing Scottish Water's capital maintenance requirements.

The majority of respondents agreed that the UKWIR approach does provide a suitable mechanism. One respondent noted that successful implementation of the framework would require Scottish Water to develop an appropriate methodology. Another respondent suggested that it could be difficult to implement the framework fully.

Our approach to assessing the appropriate level of capital maintenance is likely to depend on the detail of Scottish Water's proposed investment programme and its explanation of the detail of its proposed capital maintenance programme. Scottish Water has submitted its investment plan and we are currently reviewing this in detail.

We set out a three-stage approach to assessing the requirement for capital maintenance. This approach considers each of three investment drivers and ensures that investment in improving the quality of service to customers has already taken account of capital maintenance.

We sought stakeholders' views about our proposed approach to establishing whether Scottish Water's capital maintenance proposals are justified, well costed and meet best practice.

The majority of responses agreed with our proposed three-stage approach. Our actual approach will depend on the definition of the information we receive.

Implications of the quality programme

Investment in improving water quality and the environment has, in recent years, been the largest driver of capital investment in the water industry in Britain. This is likely to continue for the foreseeable future. It is essential to ensure that customers receive the benefit of this investment and that it represents good value for money.

Most quality investment is required to comply with European legislation and national government policy. Quality investment may also be required to improve the level of service provided to customers.

Our methodology consultation explained our approach to assessing Scottish Water's quality investment proposals. We intend to ensure that such proposals are properly defined, accurately costed and effectively and efficiently delivered.

We explained that in assessing Scottish Water's quality investment proposals we will take account of:

- Ministerial guidance on the overall objectives of the investment programme;
- the quality investment requirements identified by the *Quality and Standards III* process; and
- Scottish Water's initial and final business plan submissions.

We will require a detailed investment plan from Scottish Water. The Reporter's assessment of the proposals will also form a key part of our analysis.

We sought respondents' views about our proposed approach to assessing Scottish Water's quality investment proposals. The majority of respondents agreed with the proposed approach.

One respondent highlighted the role of other regulators in interpreting legal obligations and ministerial guidance. We do not disagree and are working closely with the Drinking Water Quality Regulator (DWQR) and the Scottish Environment Protection Agency (SEPA). In the light of concerns raised by the Reporter, we have commissioned a further examination of Scottish Water's capital programme. We believe that this study may be important in determining the allowed level of capital expenditure.

We also asked stakeholders if there were any other factors that we needed to take into account to ensure that customers receive value for money.

One respondent questioned whether the requirements for Scotland went beyond those for England and Wales and could be supported by cost benefit analysis. This is a matter for the Scottish Ministers, who set the investment objectives for the industry.

Investment to balance supply and demand

In order to meet the expectations of customers, Scottish Water must invest in its water and waste water capacity. It must also ensure that it is able to meet reasonable demand for those services.

Our methodology consultation highlighted the need to make sure that this investment is carried out in an efficient way. Investment planning is critical to this.

Our assessment of investment planning centres on whether or not Scottish Water has adopted an economic approach. This means that it should make choices about investment with reference to the costs for customers and for the environment. For example, we will require evidence that a comprehensive range of supply/demand balance options has been considered and that the costs of these have been properly estimated.

Our methodology consultation set out the elements of an economic approach, and sought stakeholders' views on our proposed approach.

Respondents generally agreed that it is important to implement a framework for assessing Scottish Water's water resource planning. However, some questioned whether sufficient information existed to do so effectively for leakage.

We also asked whether there were any other factors that needed to be taken into account to ensure that customers receive value for money. The majority of respondents suggested that sufficient factors had been captured. One respondent suggested four additional factors that should be considered.

We are reviewing suggestions from respondents and will set out in the draft determination our approach for ensuring that customers get value for money from investment to meet the Ministers' objectives.

Capital expenditure in the Scottish water and waste water industry

Our methodology consultation examined historic levels of capital investment in the water industry in Scotland, and compared these with levels of investment in England and Wales. Our analysis confirmed that:

- the size and composition of the asset base in Scotland is similar to that in England and Wales;
- the condition and performance of the assets in Scotland appears to be no worse than in England and Wales; and
- by the end of the current regulatory period, investment levels per property in Scotland will be equivalent to those in England and Wales over the previous ten and 20-year periods.

Lessons learned from establishing the baseline investment programme for Quality and Standards II

The experience in trying to determine the capital investment programme for *Quality and Standards II* has taught us that a fully defined programme must be in place at the outset of the *Quality and Standards III* process. Our discussions with SEPA and the DWQR have also led us to conclude that the outputs to be delivered by each project must be clearly defined and quantified at the outset.

A detailed baseline programme will bring benefits for customers and, as such, is an important input to the *Strategic Review of Charges 2006-10*. Capital projects such as treatment plant upgrades or pipe renewal can have a major impact on customers and local communities.

In the methodology consultation, we proposed that the baseline investment programme should be published in full. This would help ensure greater transparency and accountability. We sought stakeholders' views about whether the programme should be published, and, if so, whether it should be published in full or in the form of regional lists.

All respondents agreed that the investment programme should be published. One respondent noted, however, that it should be clearly indicated that the programme will be subject to change through the substitution process. This suggestion is in line with our current thinking.

Our methodology consultation explained that it seems increasingly likely that a significant proportion of *Quality and Standards II* will not be delivered on time. The delay in delivering *Quality and Standards II* suggests that an 'early start' programme for *Quality and Standards III* is inappropriate until a full definition of any potential overhang is agreed.

We asked stakeholders if they supported this view and most respondents strongly agreed. One respondent suggested that the overhang from *Quality and Standards II* would not impact on *Quality and Standards III*.

Ability to deliver the investment programme

The size of the programme that Scottish Water has to deliver will depend on the extent of the overhang from *Quality and Standards II* and on the investment priorities for *Quality and Standards III* that were outlined in the Ministerial Guidance.

It appears likely that there will be an overhang from *Quality and Standards II* into the next regulatory control period. We have written to Scottish Water to confirm the cash resources that we expect to allow to be carried over. We are also planning to write to Scottish Water seeking its views on handling the overhang from *Quality and Standards II*.

We asked for respondents' views on how we should treat the potential overhang from *Quality and Standards II*. The majority of responses advocated the use of a prioritisation process to identify the critical elements of *Quality and Standards II*. One respondent noted that the *Quality and Standards II* overhang should be kept distinct from *Quality and Standards III* and assessed against a set of separate deliverables.

We believe that it is important that we learn from this experience by setting a capital programme that can be delivered efficiently. This is in the longer term interests of customers, the environment and public health.

We asked respondents whether we should learn from the *Quality and Standards II* experience in setting the investment programme for the next regulatory control period. The majority of respondents confirmed their support. One respondent agreed that our analysis highlighted the issue of deliverability and suggested that further analysis could be useful.

Finally, we asked for views about whether we should adjust the efficiency target if the proposed investment programme proves to be very large. Respondents suggested that we should adjust the efficiency target. One respondent suggested that this adjustment should be downwards. We will take into account comments made in Scottish Water's second draft business plan in the draft determination.

Defining the investment programme

A baseline for the capital investment programme is the agreed detailed list of capital projects that Scottish Water will deliver during the next regulatory control period. It is a key part of the regulatory contract between Scottish Water and its customers.

Our methodology consultation outlined the process we propose to adopt in setting a capital investment baseline for the regulatory control period 2006-10. This process takes full account of experience gained during the current regulatory control period.

Our view is that the baseline investment programme should be clear, comprehensive and accessible. We outlined the detailed elements that we would require in defining the baseline capital programme. We are trying to strike a balance between the needs of stakeholders and the reporting burden on Scottish Water. We have allowed Scottish Water to combine very small capital maintenance projects for reporting purposes and hope that this will significantly reduce the information burden. In addition, we consider that the level of detail required is consistent both with the lessons learned from *Quality and Standards II* and with the reporting burden on the companies in England and Wales.

We asked stakeholders if they thought that the proposed degree of definition for the baseline investment programme was sufficient. We also asked if they had views about other information that should be captured, and why.

The majority of respondents agreed that the level of detail was sufficient. One respondent said that it was unclear whether measurements of delivery would be based on inputs or outputs. Our view is that we monitor outputs but maintain a close eye on inputs in order to understand likely progress in the delivery of outputs.

We also asked respondents if they agreed with the rationale we had given in the methodology consultation for the extent of definition of the baseline investment programme. In particular, we wanted to know if stakeholders thought that the reporting burden on Scottish Water was appropriate.

The majority of respondents agreed that this level of information should be collected. One respondent suggested that the detailed information was already collected by Scottish Water, so should not represent an onerous burden.

Another respondent was concerned that the information requirements went beyond the level of detail required by comparable regulators such as Ofwat. We are not persuaded of this, as we have endeavoured to draw heavily on Ofwat's most recent approach in determining our information requirements.

Investment programme review

The guidance that the Scottish Ministers provide on investment priorities is at a relatively high level. Scottish Water then had to translate this set of objectives into a fully defined, project-level investment programme in its second draft business plan.

An important step at that stage is for us to review Scottish Water's proposals to ensure that they meet the required objectives in the most effective way possible.

This helps ensure that costs to customers are minimised and that stakeholders' requirements are met.

Our methodology consultation explained that in reviewing Scottish Water's proposed investment programme we would work closely with the Reporter, SEPA and the DWQR. The review process may lead us to seek changes in Scottish Water's capital expenditure proposals. The revised programme will then form the baseline to which we can apply targets for capital efficiency.

Our proposal to use the Reporter to carry out the review is consistent with the approach adopted by Ofwat. We asked stakeholders if they agreed that the Reporter should undertake the review. If they did not agree, we asked who else they thought should be used for this exercise. Respondents generally agreed that it would be appropriate to use a Reporter.

Our methodology consultation set out the criteria we proposed to use in reviewing the investment programme. We sought stakeholders' views about our proposed process and whether they considered it met the needs of customers and stakeholders.

Most respondents agreed that the process would meet the needs of customers and stakeholders. One respondent was concerned that the Water Customer Consultation Panels (WCCP) would not be represented.

We also asked if stakeholders thought the proposed areas of assessment were sufficient to ensure that the programme is deliverable, takes full account of potential synergies and will meet the objectives set out by Ministers.

While in broad agreement that the assessment would ensure that the programme is deliverable, some were confused over the exact details. One respondent believed that the assessment did not fully address whether or not the programme is deliverable.

We do not have a role in questioning the objectives set by Ministers. Our review of the investment programme is designed to ensure that Ministers' objectives should be delivered for the lowest reasonable cost.

In order to ensure that we understand the lowest reasonable cost of the capital programme, we have commissioned an additional review of the investment programme contained in Scottish Water's second draft business plan. This review is being led by two consultant engineering firms.

How Ofwat assesses capital expenditure efficiency

Our methodology consultation examined different ways to assess the scope for capital expenditure efficiency. By efficiency we mean the scope for delivering the same set of objectives from the investment programme, but for less money.

Capital expenditure efficiency can be achieved in a number of ways, including improved strategic and project planning, better procurement and the use of innovative techniques.

We explained that Ofwat adopts a four-stage approach to determining the capital expenditure requirements of the companies in England and Wales. The assessment of the scope for capital expenditure efficiency is the third of the four stages. Ofwat adopts different approaches for capital maintenance expenditure and for capital enhancement expenditure.

Ofwat's methods to assess the scope for capital expenditure efficiency are well established and have been developed over a number of years. They use detailed econometric models, specific to the water and waste water industry. We asked stakeholders for their views about Ofwat's methods for assessing capital expenditure efficiency.

Some respondents supported the use of the Ofwat models. Others expressed concern that the explanatory factors within the models were too limited and placed too great a focus on efficiency at the expense of other possible factors. One respondent disagreed that Ofwat can determine relative efficiency accurately.

We are considering evidence provided by Scottish Water. We currently hold the view that these Ofwat models (with proper account taken of information provided by Scottish Water) are an appropriate way forward.

We also asked if stakeholders could suggest any other approaches to assessing the scope for capital expenditure efficiency. One respondent suggested that we should use a range of statistical techniques to support our analysis. Another recommended including an assessment of best practice. A third suggested using existing capital expenditure efficiency targets established by Ofwat for Scottish Water's partners in its joint venture company Scottish Water Solutions – United Utilities and Thames Water.

We are not yet persuaded of the practicality of these approaches.

Other ways to assess capital expenditure efficiency

Our approach to determining the scope for capital expenditure efficiency targets in the *Strategic Review of Charges 2002-06* drew on Ofwat's approach. However, we had to adapt the approach to reflect the limited information that was available to us at that time concerning the Scottish water industry.

The methodology consultation presented an overview of the approaches taken by the economic regulators of the electricity, gas, rail infrastructure, telecommunications, post and aviation industries in assessing the scope for capital efficiency. There is no standard regulatory approach, as regulators have tailored their approach to the particular characteristics and asset bases of the industry they regulate.

We are keen to take account of different regulatory approaches and asked stakeholders if there were any lessons we could learn from the experience of other regulators.

Respondents generally believed that the experience of other regulators was valuable, but could not be directly applied to the Scottish water industry. We broadly agree with this view.

Our proposed approach to assessing capital investment efficiency

In the *Strategic Review of Charges 2006-10*, we plan to use Ofwat's econometric models and its cost base approach to assess the scope for efficiency in Scottish Water's capital investment programme. Our methodology consultation explained that we propose to adapt Ofwat's approach in order to accommodate the remaining differences in the quality of regulatory information. We outlined in some detail the econometric models and the cost base techniques that Ofwat uses.

We have collected cost base information for Scottish Water and the three former authorities since 2000-01. In 2004, we updated our requirements for cost base information to ensure that our approach would be consistent with that used by Ofwat. We can therefore apply the cost base approach to both capital maintenance and capital enhancement investment.

It is necessary for us to make some largely technical adjustments to the econometric models to ensure that we can use them to analyse Scottish Water's performance. This includes adjusting for the different timeframes of the regulatory control periods, taking account of the range of performance in England and Wales, and accounting for the characteristics of Scotland and Scottish Water.

We sought views on our proposal to use the cost base as the basis for establishing an efficient level of capital enhancement expenditure, and the majority of respondents supported this approach. One respondent was concerned that we would adopt Ofwat's view that catch-up efficiencies should be achieved in year one of the regulatory control period. Our current thinking is that we will phase catch-up efficiency targets over the first three years.

We explained that we propose to assess special factors for capital expenditure in the same way as we assess special factors for operating expenditure. We will examine very closely any justifications for increasing the cost of the investment programme. In so doing, we need to take account of any relevant factors that are beyond management control but which influence costs. Our methodology consultation explained that we asked Scottish Water, as part of its business plan submissions, to draw to our attention all factors that increase or decrease cost. To justify an adjustment because of a special factor Scottish Water would have to provide evidence in a number of areas.

Our methodology consultation asked if respondents considered that our proposed mechanisms for taking account of special factors is appropriate.

Most respondents who raised concerns about the proposed approach suggested that the range of explanatory factors within the Ofwat models were insufficient. One respondent questioned the validity of comparing Scottish Water with the English and Welsh companies. They were also concerned that recent increases in the allowed level of capital maintenance in England and Wales would not be extended to Scottish Water.

Our intention is to treat Scottish Water appropriately given its efficiency position and current level of capital maintenance spending. We are considering all of the evidence available in setting an appropriate level of spending.

The scope and pace for improvement

In our methodology consultation we explained that we need to make decisions about how quickly Scottish Water should be able to achieve efficiency improvements. We set out the approach we plan to adopt in assessing the pace for improvement. We proposed adopting the Competition Commission's approach in its review of the Ofwat 1999 price determinations for Mid Kent Water and Sutton & East Surrey Water, by phasing the required catch-up improvement over the first three years of the regulatory control period. This would give Scottish Water the opportunity to implement improvements in asset management techniques.

We are able to draw on regulatory precedent in the water and waste water industry. As we highlighted in our consultation, it is clear that Ofwat continues to believe that there is scope for further capital efficiency improvement in the water and waste water industry south of the border. The companies have been successful in out-performing the relatively challenging efficiency targets that have been set in earlier price reviews. This would indicate that there is significant scope for Scottish Water to achieve further savings in investment performance.

In the *Strategic Review of Charges 2006-10*, we proposed introducing an incentive framework that rewards Scottish Water for out-performance on investment and provides benefits to customers and stakeholders. Scottish Water would be allowed to retain a proportion of any out-performance in delivering the agreed capital investment programme. It would be able to use this out-performance to deliver additional capital investment outputs identified by stakeholders or invest in 'spend to save'. Scottish Water could take credit for adding outputs that were not funded in the original capital investment programme. Stakeholders would be asked to agree the projects to be funded. Realistically, confident judgements about progress in capital efficiency will only be able to be made towards or at the end of the regulatory control period.

We asked for respondents' views on our proposed approach to establishing the scope for improvement in capital efficiency. Most respondents agreed with the approach. One suggested that econometric models or the cost base approach were not sufficiently robust bases to assess comparative efficiency. We plan to review all of the evidence available to us before drawing any conclusions on relative performance.

We also asked if stakeholders thought we should treat capital maintenance and capital enhancement expenditure separately. Some respondents agreed that the two forms of expenditure should be treated separately. However, the majority suggested that the distinction had been previously overstated or was not appropriate to make at all.

We are minded to treat these two forms of expenditure separately. To do otherwise is likely to reduce the transparency of our approach and the validity of our comparisons with the companies south of the border.

We asked if respondents agreed with our proposals to introduce an incentive mechanism for out-performance, and if they considered that the proposed mechanism would provide appropriate incentives for out-performance.

All respondents broadly supported our proposals. However, one respondent suggested that there should be symmetry in the way out-performance and underperformance are treated.

As our methodology consultation explained, introducing incentive-based regulation should protect customers from the risk of underperformance by Scottish Water. This will only be achieved if the costs of such underperformance are met by a third party and at no cost to customers. In the public sector model this would require the Scottish Executive to provide grant-in-aid funds to make good these costs. This should ensure that the Scottish Executive scrutinises Scottish Water's performance more rigorously; it will also be less likely to increase Scottish Water's borrowing in the event of a failure to meet targets.

We asked whether respondents agreed that any future failure to meet efficiency targets should be funded by grant-in-aid from the Scottish Executive. The majority of respondents did so. One respondent suggested that it went beyond our remit to suggest how underperformance should be funded.

This approach seems to be consistent with Ministerial Guidance. Ministers have confirmed that public expenditure support to Scottish Water in the provision of its core services throughout the period 2006-10 will take the form of lending alone and that no grant will be paid in respect of these services during the period. Ministers have also endorsed the principle that customers should not be asked to pay twice for the same benefit. Customers should be asked to meet additional costs beyond those allowed for in a charges determination only where these have arisen as the result of external factors beyond Scottish Water's control.

Setting targets for efficiency in capital expenditure

The methodology consultation set out our proposed overall framework for setting targets. It explained that our approach focuses on maximising the delivery of investment outputs, which have been identified as priorities by Ministers and stakeholders, within an overall level of investment spend that is consistent with efficient delivery.

Setting challenging but achievable targets benefits customers and stakeholders. It should result in more effective investment, delivered at lower cost. Our methodology consultation set out the step-by-step approach by which we would arrive at the total allowable investment expenditure for each year of the next regulatory control period.

We asked respondents if they considered that our proposed methodology for setting targets is robust. The majority of respondents agreed. They also agreed that we should take account of the critical factors outlined in the methodology in setting investment targets for Scottish Water.

We also asked stakeholders if they thought that the scope for improvement is different between capital maintenance and capital enhancement. Some agreed, although others reiterated their concerns that separate efficiency targets should not be set for capital maintenance and capital enhancement expenditure.

Monitoring capital delivery

We believe that monitoring and reporting on Scottish Water's performance in achieving targets is critical to ensuring that customers receive value for money. Our regular Investment and Asset Management Reports provide customers and stakeholders with an objective assessment of Scottish Water's performance.

In recent years we have established a framework for monitoring capital expenditure. Our methodology consultation explained how we propose to develop this framework, and sought views on our proposed approach. Respondents were supportive.

Some respondents emphasised the importance of joint monitoring between relevant regulators to ensure effective joint planning. We concur on the importance of this. Respondents also confirmed that our regulatory reporting mechanism is sufficient to meet the needs of both customers and stakeholders.