

Stakeholder workshop 4: Scottish Water's capital expenditure

Why is Scottish Water's capital expenditure important to customers?

Scottish Water incurs capital expenditure in two ways:

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

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

We have a statutory duty to determine charges caps for Scottish Water which allow it to achieve the objectives set by Ministers at the lowest overall reasonable cost. Determining an appropriate allowance for capital expenditure is an important part of this process.

Progress at the last review

Capital expenditure was the single largest allowance in the 2006-10 price review. The process to determine an appropriate level of capital expenditure involved a number of other stakeholders. It began with Ministers and a programme of consultation.

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

Following the price review we helped to set up an Output Monitoring Group (OMG) to monitor how well Scottish Water is progressing with delivering its investment programme. The OMG is chaired by the Scottish Executive, and includes representatives from the Drinking Water Quality Regulator (DWQR), the Scottish Environment Protection Agency (SEPA), Waterwatch Scotland and the

Commission. The OMG is an important development. It increases transparency for customers and stakeholders and ensures that Scottish Water is accountable for delivering required outputs.

Issues for the next review

We propose that our overall approach to assessing an appropriate level of capital expenditure at the next review will again focus on scrutinising Scottish Water's investment plans and ensuring they represent value for money.

The process we propose to follow is broadly the same as that noted above. However, there are some critical issues associated with carrying out this process that we would welcome stakeholders' views on.

It is worth noting that an important change to the timeline and process for this review has already been made. At the last review, Scottish Water was required to submit its first draft business plan before Ministers had issued guidance on their objectives. This made it more difficult for Scottish Water to effectively target its investment proposals. At this review, Ministers will issue initial guidance prior to Scottish Water submitting its first draft business plan. We believe this will be an important change. Scottish Water will have clarity about what it must deliver earlier in the process, giving it more time to formulate its investment proposals.

A summary timeline is set out below.

Who	What	When
WICS	Issue guidance to Scottish Water on its first draft business plan	20 December 2007
Ministers	Publish outcome of principles of charging consultation and indicate future investment priorities	1 April 2008
Scottish Water	Submits its first draft business plan	30 May 2008
WICS	Provide feedback on Scottish Water's first draft business plan	31 July 2008
Ministers	Issue guidance on the principles of charging and objectives	30 September 2008
WICS	Issue guidance to Scottish Water on its second draft business plan	15 October 2008
Scottish Water	Submits its second draft business plan	13 March 2009
WICS	Publish the draft determination of charge caps	30 June 2009
Ministers	Issue Directions on objectives and principles of charging	23 September 2009
WICS	Publish final determination of charge caps	30 November 2009

Issues in detail

What size of investment programme can be delivered efficiently? – What is a reasonable amount of investment to expect Scottish Water to deliver? Is it the case that if Scottish Water is required to make too much investment, its efficiency will suffer as a consequence? How much capacity is there in the construction industry to deliver Scottish Water's investment? Could too much investment flood the construction market and cause it to over-heat? This will be an important consideration for the finalisation of Ministers objectives. We would welcome stakeholders' views.

What is an appropriate level of capital maintenance? – It can be difficult for a water company to predict how much capital maintenance it will require, particularly, as capital maintenance expenditure is often required in reaction to a fault, rather than to pre-empt it. New approaches to assessing, and planning, capital maintenance requirements are being developed. However, they require an intensive amount of information about assets – how do we compensate for the fact that Scottish Water does not yet have sufficient information to implement such an approach?

Should we allow an early start programme? It is a characteristic of the water industry in the UK that at the beginning of the regulatory control period there is a dip in investment. This tends to be because water and sewerage companies require time to formulate exact project plans, procure assets, and contract building work before actual investment starts. It places pressure on the company at the end of the regulatory control period when investment tends to peak. Can we help to mitigate these fluctuations by allowing Scottish Water to make an early start? Is this consistent with maintaining a focus on delivering the current large investment programme?

How should the delivery of investment be monitored? Ensuring objectives are delivered is an important element of providing value for money for customers. Customers should receive the outputs they have paid for. The OMG has made a good start at scrutinising Scottish Water's investment delivery for the 2006-10 review – can it play an even more important role in the next?