Strategic Review of Charges 2010–14: Methodology

Volume 4: Approach to capital expenditure

CONSULTATION

Overview

This document explains our proposed approach to assessing the level of capital expenditure to allow for at the 2010-14 price review, and seeks stakeholders' views.

Contact
Katherine Russell
Director of Corporate Affairs and Customer Service
T 01786 430200 **E** src10-14@watercommission.co.uk

water industry commission FOR SCOTLAND

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How to respond to this consultation

You can write, fax or email your representation to:

Katherine Russell
Director of Customer Service and Corporate Affairs
The Water Industry Commission for Scotland
Ochil House
Springkerse Business Park
Stirling FK7 7XE

Telephone: 01786 430200
Fax: 01786 462018
Email: src10-14@watercommission.co.uk

Please submit your response no later than **Friday 19 October 2007**.
We will publish all responses to this consultation unless respondents request otherwise.
Printed copies of this consultation are available from the address above.
Electronic versions are available on our website at www.watercommission.co.uk.

BACKGROUND

Background

Context

Every four years, we set limits on the prices that Scottish Water can charge customers for water and sewerage services. The next price review covers the period 1 April 2010 to 31 March 2014.

We issued a consultation document in December 2006, which set out our overall approach to the forthcoming review. We explained that we intended to carry out a further major consultation during 2007, which would cover the methodology we should use in coming to our decisions about price limits.

The December 2006 document explained that the methodology consultation would need to consider a number of components, and that these would be grouped into four volumes, as follows.

Methodology volume	Date volume was published
Volume 1: Financing & governance of Scottish Water	10 May 2007
Volume 2: Customer revenue, levels of service & the new competition framework	31 May 2007
Volume 3: Operating costs	28 June 2007
Volume 4: Capital expenditure	26 July 2007

This document is the last of the four methodology consultation documents.

Associated documents

- 'Our approach to the 2010-14 price review: A consultation', Water Industry Commission for Scotland, December 2006.

- 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

More detailed information about our proposed methodology in relation to assessing Scottish Water's capital expenditure is available on our website: www.watercommission.co.uk

Introduction

Scottish Water has undertaken to deliver a capital investment programme of £2.15 billion[1] between 2006 and 2010. This investment will deliver cleaner beaches, higher quality water and improved customer service in Scotland. It is, however, a very large programme. Only Thames Water is charged with delivering a larger programme in absolute terms over the same period and it serves over twice as many customers. No other water and sewerage company in Great Britain currently has to deliver the same level of investment per connected property.

In this volume, we outline our current thinking on how we should determine the capital expenditure to allow for when setting prices. We would like to hear stakeholders' views on the following questions:

1. What are respondents' views on how we propose to assess the size of investment programme that Scottish Water should be expected to deliver efficiently?

2. Do respondents have views on how we propose to define the scope of the investment programme required to deliver ministerial objectives for the water industry?

3. What are respondents' views on how we propose to determine an appropriate allowance for capital expenditure?

4. Should we consider an application by Scottish Water for an 'early start' to delivering the required investment outputs for 2010-14?

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

Scottish Water's capital expenditure accounts for almost half of its total annual spending. The level and efficiency of Scottish Water's capital expenditure is therefore an important influence on the level of customers' bills, both in the coming and in future regulatory control periods. Accordingly, we propose to scrutinise Scottish Water's spending plans carefully to ensure that they represent value for money.

We also propose to work within the framework of the Output Monitoring Group (OMG) to ensure that the outputs required by Ministers and financed in the Strategic Review of Charges 2010-14 are delivered. The OMG holds Scottish Water to account for its delivery of the outputs required to achieve Ministers' objectives (irrespective of whether the investment is delivered by Scottish Water itself or through partners or sub-contractors).

[1] In 2003-04 prices.

APPROACH: 2006–10

Our approach at the Strategic Review of Charges 2006-10

At the Strategic Review of Charges 2006-10 we considered capital maintenance and enhancement investment separately.

Capital maintenance

We compared the level of Scottish Water's proposed spending to maintain the performance of its assets with the levels of spending committed by companies south of the border. It was clear that these companies had committed much less investment, yet the performance of their assets had not deteriorated.

The average company operating south of the border would have required just under £600 million over four years to have maintained the performance of Scottish Water's asset base.

We considered it prudent to allow for additional capital maintenance by Scottish Water to address leakage, improve information about the asset base and address other priorities of the quality regulators that were not specifically included in the ministerial objectives. We further increased the allowance to reflect Scottish Water's relative inefficiency in delivering capital investment.

Our allowance for Scottish Water's capital investment in the Strategic Review of Charges 2006-10 was £800.6[2] million over the four years. This was broadly similar to the allowance claimed by Scottish Water after an adjustment was made for our analysis of its inefficiency in procurement.

In our conclusions we emphasised that Scottish Water had to make considerable progress in improving its understanding of its asset base. We noted that, in the absence of much better information, it would not be possible to use the UKWIR common framework[3] in the Strategic Review of Charges 2010-14.

Enhancement investment

Enhancement investment is designed to bring about improvement in Scottish Water's overall performance. This investment would, for example, improve compliance with water quality or environmental discharge standards, improve customer service, reduce leakage rates or release constraints on development.

[2] In 2003-04 prices. For further information see Volume 5, Chapter 20, Table 20.3 of 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

[3] Capital Maintenance Planning: A Common Framework (CMPCF) is a common framework developed by UKWIR for the UK water industry in relation to its approach to capital maintenance planning. The principles of the CMPCF have been widely accepted and are being progressively implemented by water services providers.

Our assessment of Scottish Water's investment proposals for enhanced levels of service considered:

- whether the proposed investment was properly defined and consistent with ministerial objectives;
- whether the scope of Scottish Water's capital investment programme was consistent with the ministerial objectives;
- whether the costing of the proposed investment programme was reasonable; and
- the extent of efficiency improvements that should be required.

Consistency with Ministers' objectives

We worked with both the Drinking Water Quality Regulator (DWQR) and the Scottish Environment Protection Agency (SEPA) to ensure that we understood their interpretation of the ministerial objectives. We asked them to review the list of projects proposed by Scottish Water and to confirm that delivering all of the specified projects would satisfy the ministerial objectives in full.

Challenge to the proposed scope of works

We asked an independent Reporter to review Scottish Water's proposed investment programme. We were interested in his assessment of the scope of the programme and the appropriateness of the solutions put forward by Scottish Water.

The Reporter's assessment of Scottish Water's investment proposals highlighted concerns with regard to the scope of works proposed, particularly in elements of the environmental and drinking water quality programmes. We therefore carried out a detailed assessment in this area using experts from Ofwat and Faber Maunsell, along with in-house expertise.

Our review of the proposed programme and the conclusions of both the Reporter and Faber Maunsell led us to reduce the level of investment allowed for to meet the ministerial objectives.

Faber Maunsell concluded that the water quality programme appeared to go beyond what was required by the ministerial objectives. The DWQR also confirmed that the water quality improvements should be achievable for considerably less than had been proposed by Scottish Water.

Faber Maunsell also noted that the proposed costs for addressing unsatisfactory intermittent discharges (UIDs) were excessive. Their comments were confirmed by information about the unit costs for addressing UIDs which Ofwat provided to us.

Accordingly, we determined that there was evidence of significant over-scoping of requirements. As a result we adjusted the projected costs (before applying efficiencies) of the UID and water treatment works programmes.

APPROACH: 2006–10

Costing the investment programme

Scottish Water had asked its joint venture company Scottish Water Solutions[4] to cost the delivery of the ministerial objectives. In his review of Scottish Water's proposed investment programme, the Reporter highlighted some concerns about how the costs of Scottish Water's proposed investment programme had been estimated. His work identified much higher than expected costs for small treatment works. We therefore adjusted the level of investment that was allowed for to reflect the inflated cost that Scottish Water had proposed.

The scope for efficiency

We used Ofwat's cost base technique to assess the scope for efficiency in Scottish Water's proposed capital investment programme. This technique uses cost estimates submitted by all of the British companies for a wide range of standard projects to assess the companies' relative efficiency in procuring capital projects. The Reporter for each company confirms that the cost estimates for a company's proposed investment programme are consistent with that same company's cost estimates supplied for the standard projects. This technique allows the relative efficiency comparison for the standard projects to be applied to the investment programme that is required in a regulatory control period.

This analysis allowed us to reduce Scottish Water's estimate of the cost of meeting the ministerial objectives by a further 20%.

The Commission's allowance for enhancement investment

We allowed for £1.2 billion of enhancement investment to meet the ministerial objectives. This was 40% less than the £2.0 billion that Scottish Water had said was required.

Our overall conclusions on capital expenditure

Scottish Water's second draft business plan suggested that it would require £3.4 billion to deliver all of the ministerial objectives for the 2006-10 regulatory control period. In addition, more than £250 million of investment, financed in the 2002-06 regulatory control period, remained to be delivered.

We concluded that Scottish Water should deliver all of the ministerial objectives and the investment remaining from the previous regulatory control period for £2.15 billion.

[4] Scottish Water Solutions is a joint venture between Scottish Water and two consortia, one led by Thames Water and the other by United Utilities. This joint venture was charged with delivering around 70% of Scottish Water's investment programme in the 2002-06 regulatory control period.

Our proposed approach at the 2010-14 review

Our scrutiny of Scottish Water's investment plans is designed to ensure that they represent value for money. We propose the following separate steps:

Before Ministers finalise their objectives:

1. Establish that the investment programme is no larger than can reasonably be delivered efficiently.

After Ministers have finalised their objectives:

2. Ensure that the investment programme is properly defined.

3. Review the scope of the programme to ensure that it delivers ministerial objectives for the industry but does not go further than required.

4. Consider carefully the appropriate level of capital maintenance.

5. Assess whether further investment is required to allow Scottish Water to deliver the improvements in the overall performance assessment (OPA) that we propose to require.

6. Analyse the scope for more efficient delivery of the investment programme.

Establishing that the investment programme can be delivered efficiently

In our Strategic Review of Charges 2006-10, we made it clear that £2.15 billion over four years represented a very large investment programme. We noted that it would be critical that Scottish Water should not fall behind if it was to deliver the programme successfully within the regulatory control period. Yet Scottish Water has made a slow start in delivering the ministerial objectives in the current regulatory control period.

In our view this emphasises the importance of setting ministerial objectives that can be delivered efficiently within the regulatory control period. We will therefore provide advice to the Scottish Ministers about how their objectives can be met as efficiently as possible. Efficient delivery is likely to play an important part in maintaining customer support for investment to improve public health and the environment.

In our view the following factors should be taken into account in determining the extent of investment that can be efficiently carried out in a single regulatory control period:

- Scottish Water's capability to manage delivery of the investment programme;
- the extent to which a strategic approach to major improvement initiatives is adopted;
- the capacity of the Scottish civil engineering contracting industry to deliver the programme without a significant increase in prices; and
- the extent of disruption that can be borne by local communities as a result of investment to improve Scottish Water's assets.

Scottish Water's capability

Scottish Water's capability to deliver its investment programme will depend on the range of outputs required. The greater the number of smaller projects, the more difficult it will be for Scottish Water to manage the programme efficiently. Addressing issues such as climate change may also require newer and more innovative solutions.

Adopting a strategic approach to major improvements

Major drainage improvements in some areas may take many years to complete. In the past, the industry has often adopted a piecemeal approach to such improvements. While this may occasionally have reduced costs in the short run, it is likely, in most instances, to have led to much higher costs in the long run. This is clearly not in the interests of customers. We are keen to explore with stakeholders the scope for greater long-term planning (an effective response to the Glasgow Strategic Drainage Plan would be a useful example). We recognise that this could require us, as the economic regulator, to make longer term commitments to some initiatives and to take such longer term commitments into account in setting prices. We would look to other parties to commit to making their contributions to the funding of long-term projects.

Scottish civil engineering capacity

The Scottish civil engineering market is estimated at £1.8-2.0 billion a year. Current water industry investment is more than £400 million a year and accounts for approximately 20-25% of the total market. In coming to a view on the capacity of the civil engineering industry to deliver the required level of investment it will be important to take account of other planned infrastructure projects and major one-off initiatives, such as the London Olympics in 2012 and potentially the Commonwealth Games in Glasgow in 2014. Clearly, the industry could respond to some increase in demand but it is not in customers' interests if their response results in higher prices as other less profitable projects are delayed. We therefore propose to consider evidence on the extent of the industry's capacity both in Scotland and in the rest of Great Britain.

Disruption to local communities

There will be an on-going programme of investment to improve the environment and public health for the foreseeable future. It is important that these improvements are delivered with the minimum possible disruption to local communities. Otherwise there is likely to be increasing local concern about the level of activity, which may impact on delivering investment timeously (so threatening compliance with legal standards). Contractors may seek to include the costs of any such delays in their prices. This would be to the detriment of customers.

We propose to consider evidence about the extent of investment that can be delivered whilst minimising local disruption, and will discuss our conclusions with both the Scottish Ministers and Scottish Water.

Ensuring that the programme of investment is properly defined

We will issue guidance to Scottish Water concerning its draft business plans on 20 December 2007 and 15 October 2008. Our information requirement for the capital investment programme for 2010-14 is central to that guidance. In this regard, it is important to emphasise that we will hold Scottish Water to account for the definition of the capital programme – although it is clearly for Scottish Water to decide how best to meet our regulatory requirements.

In September 2008, Scottish Ministers will issue updated guidance setting out the investment outcomes[5] they require Scottish Water to deliver over the regulatory control period. We will ask Scottish Water to define a baseline for its capital investment programme that is fully consistent with the ministerial guidance. This baseline will be an agreed and detailed list of outputs[6] that Scottish Water will deliver during the regulatory control period. It is a key part of the regulatory contract between Scottish Water and its customers.

The baseline investment programme should be clear, comprehensive and accessible. This will allow stakeholders to monitor Scottish Water's progress in delivering the investment programme. It will also ensure that stakeholders' expectations are met.

It will be critical that Scottish Water agrees the outputs of its enhancement investment programme with SEPA and the DWQR. Both SEPA and the DWQR should agree that the outputs proposed by Scottish Water will achieve the outcomes required by Ministers.

We propose to require Scottish Water to include the following elements in its investment programme baseline:

- **A detailed list of projects**: this should include all of the outputs required to meet the ministerial objectives for improving service to customers and compliance with water and waste water standards (including capital maintenance priorities).

- **Clear cost allocations**: the baseline should explain the drivers of each output and allocate costs to each driver, explaining the basis of the allocation.

- **Clear separation of enhancement investment and capital maintenance**: the baseline should establish whether the required output would be achieved through normal capital maintenance, accelerated capital maintenance (ie capital maintenance that has had to be brought forward) or enhancement investment. Costs should be allocated to each of these types of investment.

- **A profile of the proposed delivery of outputs**: This should include
    - the annual projected investment spend for each project – this should include any expenditure either before or after the regulatory control period;
    - key project milestones (for example when planning consent is expected to be granted);

[5] An outcome is the actual change required. For example, an improvement in the environmental quality of 200 kilometres of river.
[6] An output is the action by Scottish Water that will lead, or contribute to, the achievement of the outcome.

- the expected completion date of each project;
- the deadline by which each stage of a project should be complete if it is to be delivered within the regulatory control period.

This information will help us to monitor progress in project delivery, both in terms of time (ie, is the project running to schedule or delayed?) and spend (ie, is spending above or below the expected amount?).

If Scottish Water expects an overhang from the investment financed under the current 2006-10 Strategic Review of Charges it should provide a similar profile for the outputs that would be delivered after March 2010.

We believe that defining the required outputs in this way is proportionate. It is in the interests of all stakeholders, including Scottish Water, that the outputs of the investment programme are clearly defined. This definition must be sufficient to minimise future disagreements about what has to be delivered.

Reviewing the scope of the programme

We explained above the detailed information that Scottish Water must provide in support of its planned investment programme. We propose to ask the Reporter to carry out a detailed review of this information, with particular emphasis on an audit and challenge of:

- the scope of requirements,
- the technical solutions proposed, and
- the basis of cost estimates and their consistency with Scottish Water's cost base.

We will ask the Reporter to draw on his experience with other companies in carrying out this review. We also expect to work closely with both SEPA and the DWQR. Our review of Scottish Water's proposed baseline is the first step in ensuring that Scottish Water's capital investment proposals meet the requirements of stakeholders and provide value for money to customers. It ensures that the scope of the proposals is appropriate to achieve the objectives set out by Ministers, and that the expenditure is being effectively targeted.

It is important to make sure that the programme delivers the outputs and objectives set by the industry stakeholders. Equally, we should identify and remove any outputs that are not consistent with the Ministers' guidance. We may seek independent confirmation of our review from industry experts.

Our review will consider the following issues:

- Does the programme meet the objectives set out in ministerial guidance?
- Does it meet these objectives in the most effective way possible?
- Is the programme sufficiently well defined to allow customers and stakeholders to monitor delivery?
- Are stakeholders able to confirm that the proposed programme delivers the agreed objectives?

- Are the solutions proposed by Scottish Water appropriate and do they represent best practice?
- Is the programme properly costed? Are the costs of the programme transparent and accountable?
- Is any of the proposed investment associated with outcomes that are only required beyond the current regulatory control period?
- Are the proposed timescales for delivering the investment outputs appropriately detailed and realistic?

The output of our review should be a properly costed, fully defined list of the outputs of capital investment projects, which, if delivered in full, will meet the objectives set out by Ministers for the regulatory control period.

The appropriate level of capital maintenance

Ofwat employs a four-stage approach linked to the UKWIR common framework for capital maintenance planning[7]. Unfortunately, there is currently insufficient information available in Scotland to implement the common framework. We allowed for £15 million in the Strategic Review of Charges 2006-10 for Scottish Water to improve its information in this area. However, it is still likely to take several years before we have the necessary information (of sufficient quality and over a sufficient time period) to make significant progress in this area. We are working with Scottish Water to ensure that the necessary information is identified and collected.

In order to ensure that we improve our understanding of the required level of capital maintenance, we propose to ask Scottish Water to set out its plans for capital maintenance in as much detail as possible. We recognise that some capital maintenance is reactive and is undertaken in response to particular problems. Scottish Water's investment programme could allow for some such spending by defining some of the inputs rather than the specific outcomes to be achieved. It is important, however, that resources that were allowed for capital maintenance are not directed to enhancement projects that have exceeded their planned budget.

We propose to use Ofwat's econometric modelling techniques to establish an initial estimate of the appropriate allowance for capital maintenance. This technique uses statistical regression analysis to establish a relationship between the costs incurred by companies and a defined set of cost drivers.

The purpose of each model is to establish a relationship between the costs reported by the companies and external cost drivers. These cost drivers have a significant impact on costs but are outside the control of the management of the company. By controlling the principal external cost drivers in the models, we can determine the amount of capital maintenance that should be allowed for with some accuracy.

[7] The four stages of Ofwat's approach are:

- Stage A: Maintaining serviceability to customers to date.
- Stage B: Is the future period different?
- Stage C: Scope for improvements in efficiency.
- Stage D: Impact of the enhancement programmes.

PROPOSED APPROACH: 2010–14

Ofwat published a consultation on its econometric models in May 2007[8]. There are nine models for capital maintenance expenditure:

- water resources and treatment,
- water distribution infrastructure,
- water distribution non-infrastructure,
- water management and general,
- sewerage infrastructure,
- sewerage non-infrastructure,
- sewage treatment,
- sludge treatment and disposal, and
- sewerage management and general.

The cost drivers that are included within the econometric models are known as 'explanatory factors'. The models themselves take different forms. These are summarised in Table 1.

Table 1: Summary of econometric models and explanatory factors

Model	Model type	Explanatory factor(s)
Water resources and treatment	Unit cost	Total connected properties
Water distribution infrastructure	Log linear	Length of main; total connected properties
Water distribution non-infrastructure	Log linear	Pumping station capacity; water service reservoir and storage tower capacity
Water management and general	Log linear	Billed properties; proportion of billed properties that are non-household
Sewerage infrastructure	Log linear	Length of sewer; number of combined sewer overflows
Sewerage non-infrastructure	Unit cost	Number of pumping stations
Sewage treatment	Log linear	Total load; total number of works
Sludge treatment and disposal	Unit cost	Total weight of dry solids
Sewerage management and general	Unit cost	Billed properties

We will revise the econometric models used by Ofwat by including information from Scottish Water. In addition, we propose to consider any special factors that may be significant in the Scottish context but which have not been fully reflected in our modelling.

We propose to increase the modelled estimate of the amount of capital maintenance required in order to reflect the capital efficiency gap that exists between Scottish Water and the

[8] 'Capital maintenance relative efficiency modelling for the 2009 periodic review', Ofwat, May 2007.

companies south of the border. We propose to use the Ofwat cost base technique to establish the size of any efficiency gap.

In our view, it will also be important to compare the results of our analysis against a range of other high-level approaches to assessing an appropriate allowance for capital maintenance. This would include assessing whether it is necessary to increase the level of spending in this area from the levels that have been seen since 2002. We propose to take account of Scottish Water's business plans in finalising our approach to determining the level of capital maintenance to allow for in prices.

Improving Scottish Water's OPA score

In our view, it should be possible for Scottish Water to achieve the improvement in its OPA score that we are likely to require without significant capital expenditure. There are two possible exceptions:

- investment to reach the economic level of leakage, and

- investment to improve compliance at waste water treatment works.

We propose to ask Scottish Water to identify any such need for investment. Scottish Water should set out exactly why capital investment is required and why the improvement is not deliverable through normal capital maintenance, the enhancement investment programme already required to meet ministerial objectives or an improvement in operational practice.

We propose to scrutinise any claim very carefully and to seek the views of both the Reporter and the quality regulators before allowing for any such additional investment. To that end, we will consider the experience of the companies south of the border. If we decide that investment is required to meet our expectations with regard to improvements in the OPA, we will apply a similar efficiency challenge to Scottish Water's claim.

The scope for efficiency

Customers have a right to expect that Scottish Water will deliver its agreed investment programme as efficiently as possible. Inefficient spending results in higher bills and/or reduced outputs. Capital efficiency can be achieved in a number of ways, including improved strategic and project planning, better procurement and the use of innovative techniques.

We propose to use Ofwat's cost base technique to assess the scope for efficiency in Scottish Water's procurement. We are currently consulting with Ofwat to determine whether we can work jointly on our use of the cost base approach.

We propose to follow the same basic approach as Ofwat. As discussed earlier, we will review the proposed programme in detail. We will then use a 'benchmarking' technique to assess the scope for improvements in capital procurement efficiency for Scottish Water.

Benchmarking

Benchmarking is the process of comparing performance across (or within) organisations. We use a 'top-down' approach involving high-level comparisons of costs and performance between companies to establish relative efficiency. The Ofwat cost base technique uses capital works unit costs to assess the relative efficiency of water companies in procuring and implementing capital projects.

The cost base was first used at the 1994 price review in England and Wales and has been used at each price review both in Scotland and in England and Wales since then. The cost base approach to assessing relative efficiency has been subject to detailed scrutiny by the Monopolies and Mergers Commission and the Competition Commission. Both found the approach to be fit for purpose.

The cost base is a database of costs, termed 'standard costs', for a wide range of standard projects, or units of work. These standard projects are typical of investment in the water industry. There are standard projects for the water and sewerage services, and for maintenance and quality investment. We can compare the standard costs submitted by the water companies to assess relative procurement efficiency.

The approach is summarised in Figure 1.

Figure 1: The cost base approach

1. Review company submission for material non-compliance, omissions and/or errors
2. Review Reporters' reports
3. Request clarification, if necessary
4. Adjust standard costs, if appropriate
5. Exclude standard costs with engineering judgement grades of less than B3
6. Exclude standard costs where compliance is not adequately confirmed
7. Factor in regional price variations as appropriate
8. Identify benchmark costs/companies representing >3% of industry turnover
9. Obtain independent endorsement of relevant benchmark
10. Calculate the % adjustment to each standard cost
11. Weight the adjustments with forecast capital investment for the next regulatory control period
12. Derive catch-up improvement targets

Review Scottish Water's submission

We propose to review Scottish Water's submission to ensure that:

- the standard costs meet our specification and guidance;
- the engineering judgement grades have been correctly applied; and
- Scottish Water has derived its standard cost estimates independently.

Company-specific factors

We will consider any special factors that Scottish Water brings to our attention. We also propose to take account of evidence about regional variations in the cost of construction, labour and tenders.

Benchmark selection

We propose to apply the same criteria as Ofwat in determining the appropriate benchmark. The benchmark should meet the following criteria:

- the standard cost closely complied with the standard cost specification;
- at least 3% of the industry (measured in terms of turnover) reported unit costs at or below the benchmark standard cost; and
- the benchmark has been independently endorsed.

Scope for improvement

We propose to set our capital efficiency target for Scottish Water having:

- calculated the adjustment for each standard cost; and
- weighted the adjustment with forecast capital investment for the next regulatory control period.

The adjustment to the standard cost is based on the gap between that standard cost and the benchmark, and the scope for closure of that gap. Adjustments are derived for each submitted standard cost for each company. In order to derive the overall improvement required, each adjustment is weighted using Scottish Water's forecast capital investment for the regulatory control period. We propose to require Scottish Water to narrow 75% of any assessed gap in its efficiency.

Monitoring delivery of agreed outputs

The Scottish Executive agreed to our recommendation in the Strategic Review of Charges 2006-10 to set up the OMG. We considered that it was important that all stakeholders could monitor Scottish Water's progress in delivering outputs objectively. In our view this required an agreed single source of information on progress. The group can also jointly discuss any changes to the proposed outputs that are required to meet the ministerial objectives. Likewise, if a change to the ministerial objectives is required, the OMG can jointly propose this change.

The OMG has approved a reporting format which allows progress to be monitored against the original target. It is also possible to monitor any changes in the expected delivery profile. Perhaps most importantly, this reporting format provides an early warning of any risk to delivery of the agreed outputs within the regulatory control period.

As noted earlier, we propose to build on this progress by asking Scottish Water in its business plans to set out its expected delivery profile for each agreed output and to indicate the progress that it will have to have made, at the end of each quarter, if the agreed outputs are to be delivered in full during the regulatory control period.

We propose that the OMG should publish this information at the start of the regulatory control period and report on progress annually.

Early start to delivering 2010-14 regulatory control period required outputs

In our view, an early start to delivering the outputs required in the next regulatory control period could be important. We believe that a properly defined early start could help avoid the significant dip in output delivery that often characterises the start of a regulatory control period.

We expect that Scottish Water will want to request that it begins to work on delivering 2010-14 outputs during the current regulatory control period. Any such request will have to meet the following criteria:

- It is restricted to the assessment of feasibility, design, land purchase or activities required to gain planning or other regulatory consents (unless there are good strategic reasons for advancing proposed investment – such as visiting the same site twice in a short period).
- It is proportionate given the likely size of the investment programme for the 2010-14 regulatory control period.
- It will not lead to additional delays in delivering outputs required in the current regulatory control period.
- Scottish Water accepts that any early start spending will have to be included within the allowance for capital expenditure that is contained in our final determination of the Strategic Review of Charges 2010-14.

We propose to ask Scottish Water to detail any proposals for an early start programme in its business plans. We are obviously concerned that the regulatory process facilitates the long-term planning of the capital investment programme. As such we are open to initiatives that would help ensure that there is no repeat of the slow start to the delivery of the current capital programme.

Summary of our approach to allowing for capital expenditure at the Strategic Review of Charges 2010-14

SUMMARY

We propose to adopt different approaches to setting targets for capital efficiency in capital maintenance and in quality enhancement expenditure.

We plan to review carefully the detailed baseline investment programme submitted by Scottish Water. Our plan is then to use the Ofwat cost base approach to assess the appropriate level of quality enhancement expenditure. We will adjust downwards our estimate of the scope for efficiency if the ministerial objectives require an investment programme significantly in excess of that which our analysis suggests is deliverable efficiently.

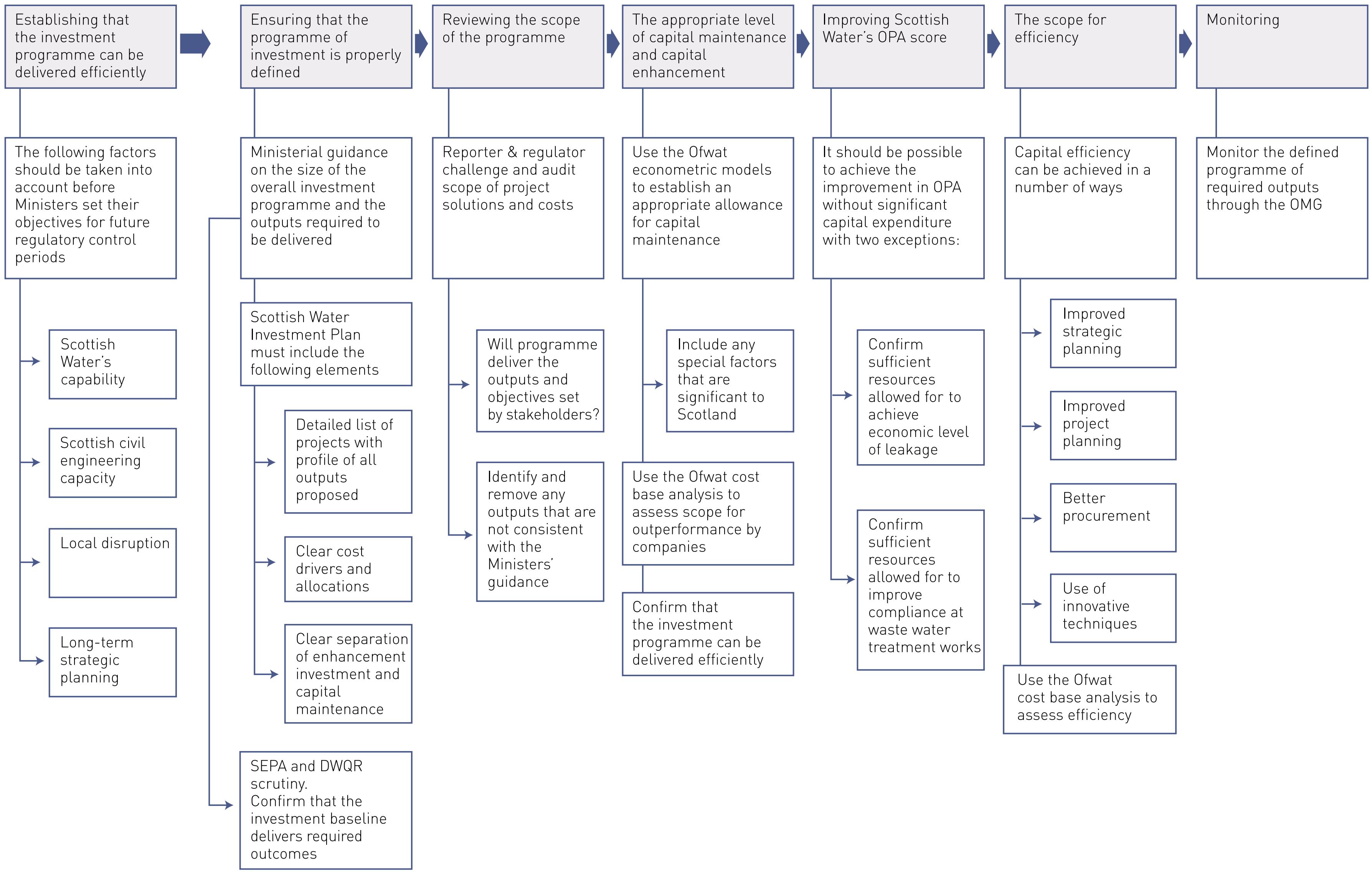
We propose to use a range of methods including the Ofwat econometric models to assess the efficient level of capital maintenance expenditure for Scottish Water. We will adjust the results of the models to reflect any special factors that impact on Scottish Water's costs. We will also use the Ofwat cost base to assess either:

- the scope for efficiency on the proposed capital maintenance programme; or

- whether we need to increase the capital maintenance allowance suggested by our modelling to reflect Scottish Water's relative inefficiency.

Figure 2 summarises our proposed approach.

Figure 2: Framework for capital investment targets



Next steps

The final date for responses to this consultation is **Friday 19 October 2007**. We encourage all interested parties to get in touch with us to express their views about our proposed approach.

We will publish a response to the consultation findings on **Thursday 20 December 2007**. Please use this opportunity to take part in the debate.

Questions for consultation

1. What are respondents' views on how we propose to assess the size of investment programme that Scottish Water should be expected to deliver efficiently?

2. Do respondents have views on how we propose to define the scope of the investment programme required to deliver ministerial objectives for the water industry?

3. What are respondents' views on how we propose to determine an appropriate allowance for capital expenditure?

4. Should we consider an application by Scottish Water for an 'early start' to delivering the required investment outputs for 2010-14?

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

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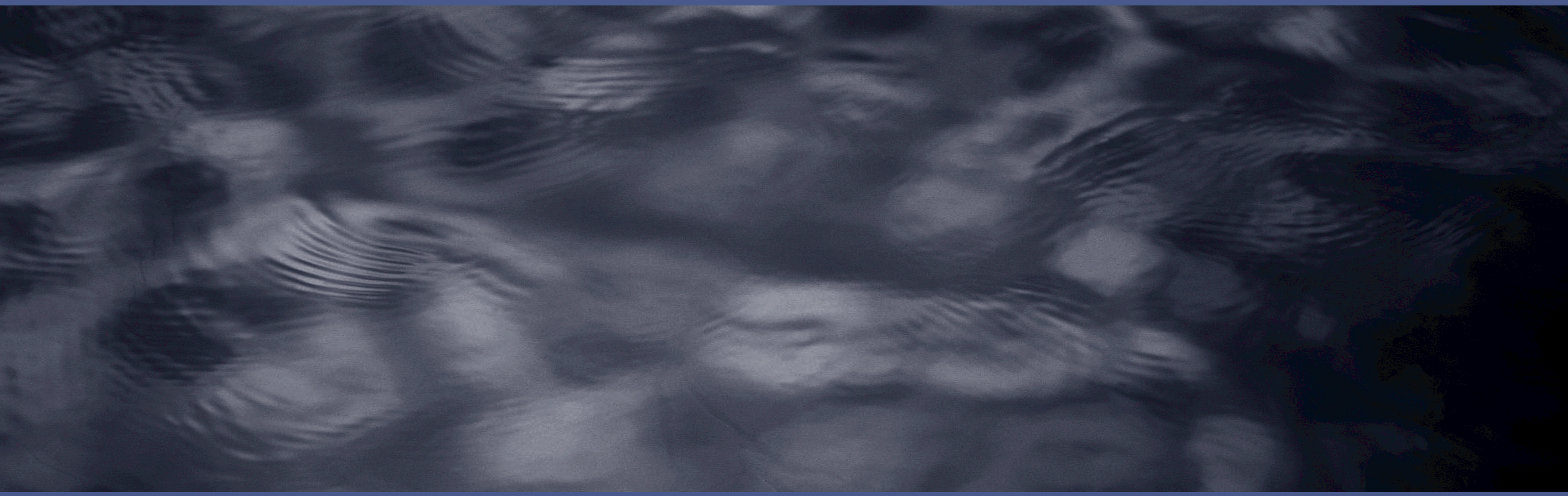

Water Industry Commission for Scotland
Ochil House, Springkerse Business Park, Stirling FK7 7XE.
T 01786 430200 **F** 01786 462018 **E** src10-14@watercommission.co.uk
www.watercommission.co.uk