

# 4

## Meeting long-term investment needs

### Introduction

This is the fourth in a series of 2018 Decision Papers that the Water Industry Commission will publish for the Strategic Review of Charges 2021-27. The Commission published thirteen Initial Decision Papers during 2017. The Commission will issue a series of further Decision Papers throughout 2018. These papers will update customers and stakeholders on the Commission's latest views and decisions for the Strategic Review of Charges 2021-27.

The 2018 Decision Papers provide the Commission's views on:

- Strategic issues facing the industry that will impact levels of service beyond the next regulatory control period;
- The prospects for customers' charges during the next regulatory control period;
- Issues that directly and materially impact the charges that customers will pay in the next regulatory control period; and
- The potential for Scottish Water to engage even more effectively with its customers.

The clarity of the governance framework for the water industry in Scotland is a significant strength. The role of the Scottish Government as policy maker, owner and banker is well defined and recognised. The objectives and principles of charging set the boundaries for the Strategic Review of Charges. As such, discussion about approaches to asset replacement planning and prioritisation of investment and compliance with European Union Directives takes place within the policy for the industry set out by the Scottish Ministers.

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review, taking account of all the evidence available to it in coming to the views set out in these Decision Papers. The final section of this paper sets out the framework for the key performance indicators that we will use to oversee the delivery of the changes to the regulatory framework.

In line with the Cooperation Agreement signed with Scottish Water and Citizens Advice Scotland, the Commission would be minded to adopt a Strategic Plan that is consistent with the Commission's Final Decision Papers and agreed with the Customer Forum as its Draft Determination.

This fourth 2018 Decision Paper sets out the Commission's thoughts on the long-term investment needs of the industry. In their Draft Investment Objectives<sup>1</sup>, the Scottish Government has made clear that the industry needs to meet future challenges in a way that avoids any shocks or significant movement in charges for customers. The creation of a joint stakeholder investment planning and prioritisation process, along with a full understanding of the asset replacement challenge, are essential pre-requisites to achieving Ministers' long-term ambitions for the industry.

<sup>1</sup> Scottish Government's Consultation 'Investing and Paying for your Water Services From 2021', Summer 2018.

# 4

## Meeting long-term investment needs

### The Commission's Expectations

In its methodology for the Strategic Review of Charges 2021-27, the Commission set out its expectations for future proofing the water industry for customers. Scottish Water should:

1. Develop a clear strategy, maximise the opportunities available to it and provide clear evidence for its approach. Stakeholders will expect to be able to scrutinise the evidence provided.
2. Adopt behaviours that build trust and make progress in instilling pride among its customers and within the communities that it serves.
3. Ensure its asset management allows it to evidence the resources that it will need to improve its performance. Develop the asset information, which will underpin effective, efficient and timely replacement of its assets.
4. Improve its efficiency and, where appropriate, take advantage of innovation to ensure that prices are kept as low as is consistent with a sustainable industry for future generations.
5. Work collaboratively and constructively with regulators and other stakeholders to identify and implement the most effective and efficient solutions.
6. Improve the transparency and frequency of its reporting on performance.

The Commission considers that there are three key building blocks of this Strategic Review of Charges:

- *Evidencing the asset replacement challenge and developing an appropriate, efficient and effective response.* The Commission is working closely with Scottish Water and other stakeholders to establish an approach to long-term asset replacement. It expects Scottish Water to develop a common understanding amongst its stakeholders of the resources that it will require in order that an appropriate transition to a sustainable level of annual investment can be put in place. Such a transition should be fair to both current and future generations. The Commission sets out its latest thinking on this issue in 2018 Decision Paper 5.
- *The introduction of a rigorous investment planning and prioritisation process.* Scottish Water will set out succinct, yet comprehensive investment appraisals that will allow stakeholders to provide an informed view on Scottish Water's proposals. Such appraisals should cover the impacts on, and views of, customers and communities. The Commission sets out its initial views in 2018 Decision Paper 3.
- *The process for evidencing financial, service level and water and environmental compliance in the coming regulatory period and beyond.* The Commission will set out its initial thinking on monitoring performance in 2018 Decision Paper 6.

# 4

## Meeting long-term investment needs

### Overview

The Commission explained in Initial Decision Paper 4 that it appears likely that Scottish Water will have to invest more in the next and subsequent regulatory control periods. Along with the ongoing requirement to invest in improving drinking water quality, environmental performance and services to customers, there are long-term challenges in areas such as asset replacement, mitigating the impacts of climate change and improving rural provision of services.

Scottish Ministers have now published their draft Principles of Charging and Investment Objectives for the next regulatory control period. These confirm the investment challenges ahead and emphasise the need for the industry to adopt a long-term perspective to meet these challenges. In particular, they note the need to meet long-term investment needs 'in a way that avoids any shocks or significant movement in charges to customers over future periods.'

To achieve this, Scottish Water will have to improve further the capacity, capability and effectiveness of its asset management processes. Stakeholders agree that Scottish Water can build the required level of trust and confidence through:

- being transparent and collaborative in all that it does;
- developing a comprehensive understanding of its assets and the associated risks;
- enabling customer, community and stakeholder input to investment choices;
- demonstrating strategic and innovative thinking;
- providing robust and accessible investment appraisals; and
- showing, through independent scrutiny, that solutions are being delivered effectively and efficiently.

# 4

## Meeting long-term investment needs

As set out in 2018 Decision Paper 3, Scottish Government and other stakeholders have agreed the principles for an investment planning and prioritisation process. This process will be an essential step to identifying and addressing long-term investment needs, while building trust among stakeholders and ensuring customers get value for money. Scottish Water has taken the lead role in defining the investment planning and prioritisation process in more detail.

Scottish Government and other stakeholders also recognise that Scottish Water has more to do to understand and evidence its long-term asset replacement needs. Scottish Water should set out a clear plan for this work and, in line with the Commission's methodology, should act as though it will be subject to verification, but seek to build the trust and confidence of its stakeholders; such that they feel that there is no requirement for a verification process. The Commission would expect to review whatever price profile is agreed in the light of both Scottish Water's progress in improving understanding of its asset replacement needs and the extent of these needs. 2018 Decision Paper 5 sets out our thinking in this area. Scottish Water has an opportunity to build the trust and confidence of its customers and other stakeholders if it proposes to 'ring fence' a proportion of the allowed for investment expenditure. This allowance would be released when Scottish Water can evidence the requirements, in line with the advice of the independent expert on asset information and asset management, and establish a consensus on the amount that will need to be spent.

The Commission will continue to work with all stakeholders to ensure that Scottish Water makes sufficient progress in evidencing the long-term investment needs of the industry. In this regard, the investment planning and prioritisation process will be important in ensuring evidenced needs are met efficiently and effectively.

The Commission will also work with stakeholders to ensure there is a common understanding of Scottish Water's performance and future prospects. Scottish Water should assure customers - through more tailored reporting of its performance - that investment is being used appropriately and that charges continue to represent value for money.

We have captured our current views in the following bullet points.

# 4

## Meeting long-term investment needs

### The Commission's thinking as it began the Strategic Review of Charges 2021-27...

- Demands on the investment programme appeared to be growing:
  - Water quality and environmental investment seemed likely to continue at least at current levels for the foreseeable future;
  - Customers have higher expectations than previously;
  - The Commission expected further growth in the number of properties that Scottish Water serves;
  - There was evidence of increasing ambition on the part of Scottish Government and other stakeholders to address the risk of flooding and improve rural provision; and
  - Asset replacement was not being adequately addressed.
- Improved efficiency could help offset the impact on customer prices. Scottish Water should also reap a long-term benefit from income growth and a reduction in costs when the PFI contracts end. However, these will not fully offset the impact on prices of higher investment levels.
- To reach a satisfactory outcome, Scottish Water would have to think and act more strategically and innovatively.
- In particular, Scottish Water would have to improve the capacity, capability and effectiveness of its asset management. This will require, amongst other things, a comprehensive understanding of asset condition.
- Scottish Water will have to evidence why it should have access to more capital expenditure in the next regulatory control period.
- Customer, community and stakeholder input to the planning and prioritisation of investment will be essential if Scottish Water is to build further trust.

# 4

## Meeting long-term investment needs

### **The Commission's joint working with stakeholders has allowed its thinking to advance both more quickly and more productively...**

- The benefits of joint stakeholder discussions – moving away from predominantly 'bilateral' engagement – are now becoming clear. There is scope to develop these multilateral conversations further. The Scottish Government, the Commission and other stakeholders expect Scottish Water to be transparent and collaborative in all that it does.
- Scottish Government and other stakeholders have agreed the investment planning and prioritisation process in principle. This process will:
  - require Scottish Water to provide transparency on its capital expenditure;
  - enable customer, community and stakeholder input;
  - facilitate a discussion of the scheduling and planning of both required and more discretionary investment; and
  - recognise Scottish Water's efforts when it adopts long-term, strategic and innovative solutions.
- Scottish Government and other stakeholders recognise that asset replacement could be more systematically addressed. Long-run asset replacement should be allowed for in customers' charges. Scottish Water must facilitate an effective conversation about the potential extent and timing of replacement investment.
- The Commission now believes it cannot set charges solely to reflect currently demonstrated needs. The Commission must, in the interests of customers, allow for a long-term transition to the likely sustainable level of capital expenditure.
- The choice of the potential price profile will have to be consistent with the Scottish Government's Principles of Charging and Objectives. The final profile will depend on the evidence that Scottish Water provides to the Commission, the Customer Forum and other stakeholders.
- Customers will doubtless want to understand the short and long-term impacts on their bills and what they are receiving for their money.

# 4

## Meeting long-term investment needs

### **The Commission is very pleased that Scottish Water and its stakeholders have engaged so regularly...**

- The Scottish Ministers have now published draft Principles of Charging and Investment Objectives. These set out their expectations for the next regulatory control period. Importantly, they require the industry to adopt a long-term perspective.
- The Scottish Ministers have also set out their expectations on the level of available borrowing. The provision of borrowing will impact directly on the cash available through the planning and prioritisation process.
- All stakeholders expect Scottish Water to show that it has considered more innovative and strategic solutions.
- All stakeholders consider that effective, concise appraisals will facilitate the planning and scheduling of investment and build the trust of customers, communities and stakeholders.
- All stakeholders agree that they need to understand the asset replacement challenge. An appropriate response to asset replacement will underpin Scottish Water's customer service, water quality and environmental performance over the long-term. This is a prerequisite of effective and sustainable asset management.
- All stakeholders expect Scottish Water to evidence the extent of its asset replacement challenge and how it plans to transition to a sustainable approach, for example in terms of the cash required, management capability and the capacity of the supply chain.

# 4

## Meeting long-term investment needs

### As the Commission is at an early stage of the Strategic Review of Charges, there are a number of outstanding issues...

- How will the investment planning and prioritisation process work in practice?
- When will the investment planning and prioritisation process need to be in place if we are to ensure continuity in the delivery of investment?
- What evidence will Scottish Water have to provide to stakeholders to demonstrate that it is capable of delivering a substantially increased programme of capital expenditure efficiently and effectively? What is the work plan to achieve this? How will stakeholders respond to this evidence?
- What is the range of appropriate price profiles?
- How will Scottish Water reassure stakeholders that it will manage its long-term risks and respond to opportunities?
  - How will Scottish Water evidence that it is developing a comprehensive understanding of its assets and the associated risks? How long will this take?
  - How will Scottish Water build the trust of its stakeholders? How will Scottish Water evidence that it has listened to the views of its regulators, customers and communities and any instructions and views from the Scottish Government?
- Will Scottish Water provide sufficient confidence to stakeholders through setting out clear commitments and milestones in its Strategic Plan? Will these allow stakeholders to hold Scottish Water to account?



# 4

## Meeting long-term investment needs

### The Strategic Review of Charges process is at an early stage. The principal next steps include...

- Scottish Water will now work closely with all stakeholders to agree the detail of the investment planning and prioritisation process. 2018 Decision Paper 3 details the approach.
- The Commission will work with experts to refine an appropriate approach to the funding of asset replacement. 2018 Decision Paper 5 details its thinking.
- The Commission expects Scottish Water to:
  - provide robust evidence to support its investment requirements and aspirations;
  - maintain and report on appropriate work plans;
  - work collaboratively with all stakeholders across all areas of the programme; and
  - build trust by demonstrating that it can manage the transition to sustainable levels of investment effectively and efficiently.
- In line with its methodology, the Commission expects Scottish Water to act as though it will be subject to verification, but seek to build the trust and confidence of stakeholders; such that they feel there is no requirement for a verification process.
- Scottish Water should work with stakeholders, customers and communities to build confidence that funding will be used appropriately - including through ensuring more tailored reporting of performance, evidencing whether a transition in charging remains appropriate and considering the use of a ring-fence around some of Scottish Water's allowed for funding.

# 4

## Meeting long-term investment needs

### Timetable for 2018 Decision Papers

The Commission sets out its current timetable for the publication of its 2018 Decision Papers in the following table.

2018 Decision Paper	Topic	Publication date
1	Scottish Water's Strategic Projections: A summary of our current thinking	25 July 2018
2	Assumptions on macroeconomic inputs and customer base growth	25 July 2018
3	Investment planning and prioritisation	25 July 2018
4	Meeting long-term investment needs	26 September 2018
5	Capital maintenance	26 September 2018
6	Performance monitoring	21 November 2018
7	Financial tramlines	21 November 2018
8	Prospects for prices	21 November 2018

# 4

## Meeting long-term investment needs

### Regulatory framework: Key Performance Indicators

Ethical Based Regulation requires a defined framework in which a regulated company is expected to operate. It offers clear benefits to a regulated company that meets and exceeds the expectations that underpin the framework. It envisions a more collaborative approach – not necessarily always working jointly on issues – that will take more informed and better evidenced decisions and build the trust and confidence of customers and communities. The Commission set out its expectations of such a ‘paradigm shift’ in its methodology for the current Strategic Review of Charges.

The Commission has been developing key performance indicators for monitoring, and reporting on, the revised framework for economic regulation. In consultation with Scottish Water and other stakeholders, the Commission has set up an EBR Review Group, which includes independent and international experts who have senior level experience in other sectors or countries. The members of this group are:

- Carlos de Regules who set up and led the National Agency for Safety, Energy and Environment for Mexico (ASEA). He was previously a Director at the Mexican Petroleum Company (Pemex).
- Steve Johnson who was previously Chief Executive Officer at Electricity North West (ENW) and has held several executive roles within the water sector.
- Jean-Yves Ollier who is a member of the French Council of State. He was previously Chief Executive of the French Regulatory Commission of Energy (CRE).

The members of this group will work with stakeholders to refine these performance indicators. Once agreed, these indicators should apply during the current Strategic Review of Charges and in future regulatory control periods. They will test whether the framework for economic regulation is meeting the expectations of stakeholders and that the Scottish industry is making appropriate progress.

The performance indicators will likely be closely linked to key delivery milestones included in Scottish Water’s Strategic Plan. There may also be a range of qualitative assessments that all stakeholders should address regularly. The aim of these regular assessments is to ensure that there is a useful common understanding of whether the regulatory framework is working for customers and communities. Doubtless, such assessments may also identify areas for improvement.

The Commission intends that the EBR Review Group meets regularly with all stakeholders throughout the period of the implementation of the new regulatory framework. They will also work closely with the OECD.

The draft framework for the key performance indicators is set out in the chart on page 12 and reflects six key building blocks outlined in the methodology. The key expectation is that Scottish Water takes full ownership of its strategy.

# 4

## Meeting long-term investment needs

The Commission trusts that the EBR Review Group will provide a useful and continuing perspective on the performance of the economic regulatory framework. It looks forward to discussing with the Group and other stakeholders the final framework.

Chart 1 – Framework for key performance indicators

