

Strategic Review of Charges 2010-14: Summary of discussions at stakeholder workshop 3 on Scottish Water's operating costs

Held on Thursday 31 May in Stirling

Present from the Office of the Water Industry Commission

Alan Sutherland	Chief Executive
Katherine Russell	Director of Corporate Affairs
Suzanne Baylis	Analyst
Harriet Towler	Corporate Affairs Manager

Stakeholders present

Katie Edwards	Scottish Water
Robert Galbraith	Freescale Semiconductors
Jack Lord	Waterwatch Scotland
Trevor Nelson	Scottish Water Business Stream
Belinda Oldfield	Scottish Water
Gerard O'Loan	NHS Scotland
John Sawkins	Waterwatch Scotland
Alan Scott	Scottish Water
Ian Smith	Waterwatch Scotland
John Struthers	Waterwatch Scotland
Bryan Wallis	Water UK
Alan Watt	Civil Engineering Contractors Association (CECA)

Opening remarks

Stakeholders were welcomed to this third workshop for the 2010-14 price review. It was explained that this workshop, which preceded the publication of the Commission's methodology consultation for the review, would focus on how the Commission should approach its assessment of the appropriate allowance for Scottish Water's operating costs.

Today's meeting coincided with the publication of Volume 2 of the methodology consultation on Scottish Water's customer base and levels of service. Comments from stakeholders at the workshop on 10 May on the same subject had helped influence this document. It was noted that the Commission hopes to capture the views of as many stakeholders as possible before publishing its methodology. Attendees were invited to raise questions throughout this workshop.

Scottish Water's operating costs are an important element of its overall costs. As such, they have a material impact on the price review and its outcome. In order to ensure that Scottish Water has sufficient operating expenditure to carry out its core duties and achieve ministerial objectives, WICS uses information from Scottish Water

to assess what its underlying (baseline) operating expenditure is, and how that baseline will change over the course of the regulatory period (for instance, from increases in pension contributions). WICS also take into account new operating costs Scottish Water expects to incur as a result of making further capital investment over the period.

It is important for customers bills that Scottish Water's allowed for operating costs are no higher than they need to be. In order to determine an appropriate level of operating costs, we compare Scottish Water's operating costs with those incurred by the English and Welsh water and sewerage companies. WICS also consider the outputs that are delivered in return for these costs. This enables WICS to assess how efficiently Scottish Water is operating, and how efficiently it could be operating (compared with what is being achieved elsewhere).

Issues discussed

1. Introduction of competition

Premise for discussion

Since the last price review, Scottish Water has created a separate entity to provide retail services to non-household customers. In order to ensure that WICS continues to make like-for-like comparisons with the English and Welsh companies, this change needs to be taken account of in the efficiency assessment. This could be done either by deducting comparable "retail" costs from the English and Welsh companies, or adding back the operating costs incurred by Scottish Water Business Stream to Scottish Water's total operating costs.

Issues raised

Attendees did not express a firm preference for either approach, but recognised the difficulties that could be encountered in adopting the former.

2. Levels of service

Premise for discussion

An important element of assessing operating efficiency is to consider the service that is delivered in return for the costs incurred. Though improving, Scottish Water is not yet providing the same level of service as the English and Welsh companies. In order to make a true assessment of Scottish Water's efficiency, WICS could take account of this difference in two ways: by setting targets for Scottish Water to improve its levels of service (by using the **Overall Performance Assessment (OPA)**); or seeking to understand the costs that would be involved in improving service. The former option has the disadvantage that it is difficult to assess 'outperformance' – for instance has Scottish Water outperformed if it has significantly reduced its costs, but missed its OPA target? The latter option has the disadvantage that it may be difficult to exactly quantify the costs involved in improving levels of service, but some companies in England (Yorkshire and Wessex) had begun to publish the information required to make such an assessment of the level of additional costs that would need to be incurred.

Issues raised

One attendee noted that for a given price, a given level of service should be offered. It was noted that in England and Wales, Ofwat assumes that all companies provide a similar level of service. Therefore no adjustment is made to the efficiency assessment. However, theoretically, those companies who offer a lower level of service to the lead companies in England and Wales would face a lesser efficiency challenge.

One attendee recognised that there was a **trade off** between levels of service and costs. Was there evidence to suggest that customers wished to pay more for a better level of service, and if so, which elements of service? Another attendee questioned how **customer preferences** could be accurately captured. Evidence from public meetings suggested it was sometimes difficult for customers to rationalise their preferences in this way, particularly if they are already satisfied with the service they receive. It was noted that it was the role of WICS to finance the objectives set by Ministers. Customer preferences were captured as part of the process to formulate **ministerial objectives**.

One attendee questioned whether there is an **optimal point** in the trade off between costs and levels of service, and if so, how this could be derived.

One attendee noted that progress with customer research was being made in the water industry to better understand this trade off, and the revealed preferences of customers. One attendee from Scottish Water noted that they hoped to work with Waterwatch in the future to investigate implementing this kind of research.

One attendee noted that this trade off should be considered in time for the **Quality and Standards IV** programme.

One attendee questioned whether carrying out further research into customer preferences in Scotland would bring into question the appropriateness of using the OPA (which assumes that customer preferences in Scotland are the same as customer preferences in England and Wales). It was noted that evidence from the customer research currently available substantiated this assumption that customer preferences in Scotland were broadly similar to those south of the border.

Another attendee questioned whether there would be a requirement for Scottish Water to make **continuous improvements** in its levels of service, as opposed to achieving a minimum standard. This had been required in the last review through the setting of milestones for improvement in performance using the OPA. One attendee noted that Scottish Water had improved its response to emergencies, and that this was evidence of continuous improvement.

3. Extent of the efficiency challenge

Premise for discussion

If an efficiency gap exists between Scottish Water and the English and Welsh companies, it is important for customers that WICS challenges Scottish Water to close this gap, but by how much? Is it reasonable to expect Scottish Water to be as efficient as the English and Welsh companies? If so, which companies should WICS compare them with – the highest achieves, the top three, the industry mid-point? And, should expected improvements in the companies' performance during 2010-14

be taken into account, or should Scottish Water be asked to perform at a level that has already been achieved?

Issues discussed

One attendee emphasised the importance of Scottish Water being required to make continuous improvements.

Attendees noted there could be presentational difficulties in requesting Scottish Water to achieve a level of performance which the English and Welsh companies had yet to demonstrate was achievable.

4. Use of econometric modelling

Premise for discussion

WICS uses **econometric modelling** to assess Scottish Water's operating efficiency in relation to the English and Welsh companies. WICS also test the results by using an alternative approach. Is it reasonable for WICS to continue to use the existing econometric models, or should other approaches be explored?

Issues discussed

One attendee noted that the use of econometric models often attracts external criticism. The models are perceived as being shrouded in mystery and a "black art". However, the attendee noted that the models were just one element of the overall process of price setting, and to that extent, this degree of attention was perhaps unwarranted.

Another attendee suggested WICS could be more open about its use of econometrics. Greater transparency, so that external parties could recreate WICS calculations, would be welcomed.

One attendee noted that work was being undertaken in the industry to develop new modelling techniques. It was noted that WICS would be concerned about introducing any untested modelling technique in isolation of its other models.

5. Other issues raised

One attendee questioned how WICS would be taking into account the Water Framework Directive (WFD) at the next review. It was noted that WICS recognised the potential for the WFD to impact on Scottish Water's investment needs and therefore customer bills. However, WICS had discussed the matter with the Scottish Environment Protection Agency (SEPA) and understood that the WFD had been taken into account in formulating ministerial objectives for the industry. WICS would continue to monitor this issue closely.

One attendee noted that it would be important to understand customers' perceptions of the industry and how it performed. In many cases customers had a poor perception of the industry. It would be important to ensure that the price review presented an accurate picture, and helped to change those perceptions.

One attendee questioned WICS would be revising its regulatory information requirements. It was noted that a review had recently taken place, and that regulatory information requests had been reduced by c.30%.

One attendee asked what actions the Commission were taking in response to the consultation on the price review methodology.

END

The Commission attaches significant importance to stakeholder workshops and would welcome any further comments or feedback that interested parties may have. Comments should be sent to Harriet Towler (harriet.towler@watercommission.co.uk or 01786 430200).

A discussion paper, issued prior to this workshop and providing further context is available on the Commission's website at www.watercommission.co.uk.

A further stakeholder workshop will be held prior to the publication of the Commission's consultation on the methodology for the price review.

Methodology volume	Publication date	Workshops
1. Financing Scottish Water	10 May 2007	26 July 2007
2. Customer revenue and levels of service	31 May 2007	16 August 2007
3. Operating costs	28 June 2007	30 August 2007
4. Capital expenditure	26 July 2007	28 June 2007 20 September 2007