

Staff Paper 6

Allowed for operating costs

This staff paper has been produced by our office to assist stakeholders in responding to the Draft Determination. The material reflected in this staff paper has informed the preparation of the Commission's proposed conclusions. However, this staff paper does not form part of the Draft Determination. Accordingly, this staff paper should not be relied upon as expanding upon or replacing anything contained in the Draft Determination.

6.1 Introduction

Since Scottish Water was formed in 2002 it has reduced its annual operating costs by almost 40%. At the same time as reducing costs, it has improved levels of service to customers. The Commission welcomes these improvements and proposes to build on them in setting prices, so 'raising the bar'.

Operating costs account for around a quarter of the money Scottish Water spends, and customers pay these costs directly through their bills. Scottish Water's performance in this area is therefore scrutinised by the Commission very closely.

Scottish Water's recent performance

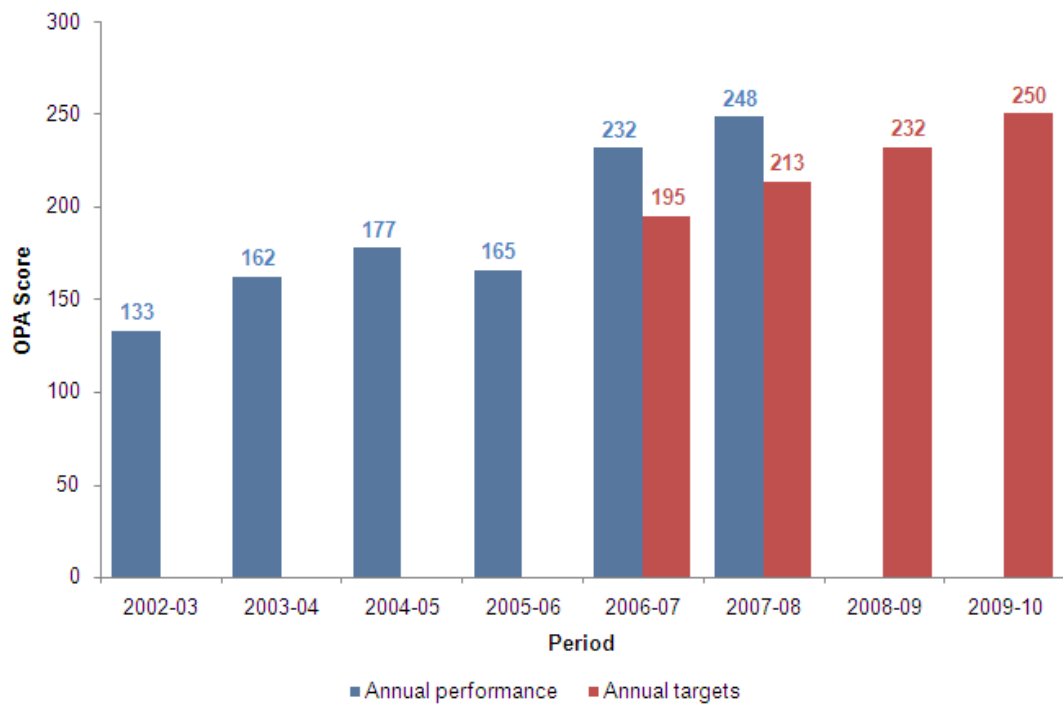
Scottish Water has improved its performance significantly. Annual monitoring of performance shows the extent of the improvement. Figure 6.1, from the Commission's 'Costs and performance report 2007-08' shows that Scottish Water achieved cost reductions of almost 40%, saving customers around £180 million a year. The report noted that Scottish Water had contained its operating costs, despite pressures from higher energy prices, more extensive water and waste water treatment processes, higher local authority rates, higher fees paid to the Scottish Environment Protection Agency (SEPA) and increased leakage detection and repair costs. In 2006-07 and 2007-08 Scottish Water outperformed regulatory challenges for operating costs, performing around 5% better than expected in both years.

Figure 6.2, from the 'Customer service report 2007-08' shows the progress made in overall levels of service to customers, measured by a points system, the 'overall performance assessment' (OPA). Scottish Water has outperformed targets that were set in the previous price review in 2005.

Figure 6.1: Scottish Water's progress on operating costs



Figure 6.2: Scottish Water's OPA targets and actual performance to date



In both its operating costs and levels of service, Scottish Water has shown a real commitment to outperform the challenges that the Commission set for it. Scottish Water's Board made the level of service to customers and financial performance important factors in the award of bonuses to management and staff.

Scottish Water's welcome improvements do not mean that further benefits to customers are unlikely. On the contrary, they enable the Commission to 'raise the bar' on performance. Comparisons with water and sewerage companies in England and Wales are critical in helping assessments to be made of the scope for further improvement and the challenge that Scottish Water should be set.

Structure of this paper

This paper begins by outlining how:

- assessments are made of the operating costs and levels of service to allow for in charges; and
- levels of service and operating cost performance are benchmarked.

The paper then sets out assessments of Scottish Water's:

- baseline operating costs;
- scope to reduce baseline costs through efficiencies, taking account of Scottish factors;
- scope to improve its levels of service performance; and
- new operating costs.

The paper concludes by outlining the allowed for operating costs and levels of service that underpin the changes proposed in the Draft Determination.

6.2 Approach to setting operating costs and levels of service in the price review

The approach to setting operating costs and levels of service has changed from that which was taken at the last price review. The new approach identifies a clear, well-defined challenge for Scottish Water. In framing the challenge, proper account has been taken of factors that affect the costs of operating water and sewerage services in Scotland.

Approach in the last price review

In the last price review, the Commission set Scottish Water annual targets up to 2010 to improve its OPA score for levels of service. This was to address a very significant gap in performance with England and Wales. At the same time, Scottish Water was set the challenge of closing, by 2010, half of the assessed gap with the operating cost performance of leading companies. The assessment of Scottish Water's performance included adjustments to reflect differences between Scotland and the rest of Great Britain in the scope of water and sewerage activities that are carried out

and in socio-economic, demographic and other factors that influence costs. In the 2006-10 Final Determination the operating costs that were allowed for in prices took account of Scottish Water's evidence regarding cost pressures arising from energy, pensions and the operation of additional purification processes for water and waste water.

Proposed challenge in this price review

Scottish Water's recent improvements in performance mean that the Commission can now set a new challenge on behalf of customers. It expects Scottish Water to match upper quartile performance for the United Kingdom on both levels of service and operating costs. Scottish Water should do this by 2013-14 at the latest. Upper quartile performance is defined as the average of the second and third placed water and sewerage companies that was achieved in 2007-08. As this paper goes on to show, this will require considerable, but achievable further improvement by Scottish Water.

The challenge to Scottish Water uses firm evidence of performance achieved by leading companies in 2007-08, rather than being based on hypothetical forecasts. The Commission believes that by linking performance to observed, proven levels there will be wide stakeholder support for the challenge. Scottish Water has already indicated in its business plans that it accepts the challenge. The Commission is confident that Scottish Water will be able to deliver. Scottish Water's recent track record of determined management would suggest that it could even outperform expectations. For this reason the Commission has decided not to set prescriptive annual targets.

6.3 Benchmarking performance

For several years Scottish Water's performance has been regularly benchmarked against its counterparts in England and Wales. To do this, the Commission uses benchmarking techniques that were originally developed by Ofwat, the regulator of the water and sewerage companies in England and Wales. The techniques for benchmarking operating costs were reviewed and endorsed by the Competition Commission in 2000 and 2007. In previous price reviews these techniques were extended to Scotland, and an alternative approach was also developed to cross-check results.

The benchmarking process requires accurate technical and accounting information about Scottish Water, collected on a basis that is consistent with information from other companies. The Commission ensures that this is the case through its regulatory information requests.

Benchmarking cannot be exact, and results require careful interpretation. In all of its benchmarking, the Commission recognises circumstances where it is appropriate to adjust results to account for Scottish factors and to account for unavoidable statistical

uncertainties in the comparisons. This approach should give stakeholders confidence that the results are as accurate as they can be.

Benchmarking levels of service performance

Scottish Water’s customer service performance is benchmarked through the OPA framework. The OPA index, which was originally developed by Ofwat around ten years ago, combines individual service measures that customers consider to be most important, such as how quickly supply is restored after an interruption, how quickly complaints are handled, and how well drinking water quality and environmental performance comply with legal requirements. The Commission considers that the OPA is the most effective measure of levels of service performance that is currently available. To work out the OPA it uses customer service information that Scottish Water provides each year. This information is scrutinised for accuracy and reliability by an independent technical Reporter.

Until recently, it was not possible to apply Ofwat’s full OPA because information about some of its components was not available reliably. The Commission worked with Scottish Water, Waterwatch, SEPA, and the Drinking Water Quality Regulator (DWQR) to widen the scope of the OPA so that it aligns fully with Ofwat’s. The new OPA will be used to assess Scottish Water’s future levels of service against the challenge of upper quartile performance. Table 6.1 sets out the current and new components of Scottish Water’s OPA.

Table 6.1: Components of the OPA

Component	Included in current OPA for Scottish Water?	Included in new OPA for Scottish Water?	Included in England and Wales OPAs?
Inadequate pressure	Yes	Yes	Yes
Unplanned supply interruptions	Yes	Yes	Yes
Hosepipe restrictions	Yes	Yes	Yes
Security of supply index: absolute	No	Yes	Yes
Security of supply index: variance against target	No	Yes	Yes
Drinking water quality	Yes	Yes	Yes
Water pollution incidents	No	Yes	Yes
Leakage	Yes	Yes	Yes
Sewer flooding incidents due to inadequate capacity	Yes	Yes	Yes
Sewer flooding incidents due to other causes	Yes	Yes	Yes
Sewer flooding; properties at risk	Yes	Yes	Yes
Waste water pollution incidents (Categories 1 and 2)	No	Yes	Yes
Waste water pollution incidents (Category 3)	No	Yes	Yes
Sewage sludge disposal	Yes	Yes	Yes
Non-compliant waste water treatment works	Yes	Yes	Yes
Customer contact	Yes	Yes	Yes
Assessed customer service	No	Yes	Yes

Benchmarking operating cost performance

Operating cost performance is benchmarked using statistical (econometric) models. These models compare operating costs across companies, and in each case they estimate the impact on operating costs of factors outside the control of management. Such factors include, for example, the size and number of water sources, the length of underground water mains and sewers, and the loads placed by customers on the sewerage system. By incorporating the impact of such factors, the models can predict, for each company, the level of operating costs that would be expected given its geography, assets and customer base alone. When actual costs are compared with these predictions, the degree to which they are higher or lower than the prediction is an indication of where cost efficiency is worse or better than average. All such comparisons between Scottish Water and the companies south of the border are adjusted to allow for factors that are particular to Scotland where these are not already included in the models.

Three modelling approaches are used to assess operating cost performance:

- the econometric models developed by Ofwat;
- a modified version of the Ofwat models (reworked to include information from Scottish Water); and
- an alternative model developed by this Office.

Using three approaches rather than one means that it is possible to consider the extent to which the results of each assessment are consistent with the others, and so can be relied on.

Benchmarking assessments using these approaches are carried out every year. For this price review, the assessment is for the year 2007-08. This is the 'base year' for the Draft Determination, being the most recent year for which full information is available from Scottish Water and the companies in England and Wales. Scottish Water's information is drawn mainly from its published 2007-08 annual return and regulatory accounts. The companies' annual returns and regulatory accounts for 2007-08 are published by Ofwat.

Ofwat's econometric models for 2007-08 are available on its website. Details of the modified version of Ofwat's models are available on the Commission's website, along with a summary of the alternative model.

Accurate benchmarking requires comparisons to be like-for-like. With two important exceptions, water and waste water provision is very similar in Scotland to England and Wales. The first important difference is that a competitive market for retail water and sewerage services to non-household customers was established in Scotland in April 2008. This required Scottish Water to set up a separate business to provide retail services in the market. This no longer forms part of the core, regulated business. In the benchmarking, any impact from this separation in Scottish Water's information for 2007-08 is removed. Performance comparisons with England and Wales are therefore like-for-like for the whole business, including retail. The second important difference is that public private partnerships deliver the majority of waste

water treatment and disposal services in Scotland. The costs of these services are accounted for separately and are excluded from the benchmarking of operating costs.

An explanation is provided later in this paper of how the operating costs that exclude the retail services are determined, which then apply to Scottish Water's core, regulated business.

6.4 Baseline costs in 2007-08

The assessment of the operating costs to allow for begins with an assessment of Scottish Water's baseline of operating costs in 2007-08 (the base year for the price review). The baseline should reflect Scottish Water's normal operating costs, from which it is possible to assess the impact of future cost changes to allow for in prices. Detailed information from Scottish Water's regulatory accounts for recent years and particularly 2007-08 is used to inform this assessment.

The assessment of baseline costs is for Scottish Water before the opening of the retail market for non-household customers in April 2008. Scottish Water's retail arm, Business Stream was set up as a separate business in November 2006. The baseline that is calculated reincorporates the normal ongoing operating costs of Business Stream in its first months of operation, so that the baseline is on a like-for-like basis with previous years and with the companies in England and Wales.

In the assessment, the impacts of one-off costs and savings that are considered to be atypical of Scottish Water's normal operating costs are removed. This adjustment is carried out on the same basis as Ofwat. The assessed baseline also excludes the cost of activities that are unregulated and excludes public private partnership costs, which are assessed separately.

The calculations are set out in Table 6.2.

The Commission is confident that its assessment of £270 million a year as Scottish Water's core baseline operating costs for 2007-08 is robust. It notes that Scottish Water's baseline operating costs have been stable since 2005-06, as outlined earlier and as shown in Figure 6.1.

Table 6.2: Scottish Water's baseline operating costs for 2007-08

Item	Adjustment	£m	£m
Reported operating costs for the water service			142.8
	Add back atypical savings on the provision for bad debt	8.5	
	Deduct costs of service level agreements with retailers	-1.3	
	Deduct CMA set up costs	-0.9	
	Deduct wholesale revenue management costs incurred before market opening	-1.3	
	Deduct unregulated costs	-0.3	
	Deduct FRS 17 pension adjustment ¹	-1.9	
Baseline operating costs for the water service			145.6
Reported operating costs for the waste water service			248.4
	Deduct PPP costs	-127.6	
	Add back atypical savings on the provision for bad debt	9.1	
	Deduct costs of service level agreements with retailers	-1.3	
	Deduct CMA set up costs	-1.1	
	Deduct wholesale revenue management costs incurred before market opening	-1.1	
	Deduct unregulated costs	-0.3	
	Deduct FRS 17 pension adjustment	-1.9	
Baseline operating costs for the waste water service			124.3
Total core baseline operating costs for water and waste water			270.0
	Add back operating costs of the retail business	18.6	
	Deduct atypical operating costs of the retail business	-3.9	
Baseline operating costs of the retail business			14.8
Total vertically integrated baseline operating costs for water and waste water			284.7

¹ The FRS 17 'Accounting for Retirement Benefits' adjustment is removed from the operating cost baseline as it is a non-cash adjustment.

6.5 Additions to future baseline operating costs

In its draft business plan Scottish Water claimed that by 2010 there would be significant increases in its normal baseline operating costs from those reported in 2007-08. The Commission is not persuaded by Scottish Water's evidence and formed its own assessment, drawing on independent evidence. The Commission's allowance is considerably less than Scottish Water's claim.

The assessment of Scottish Water's future baseline costs takes account of potential changes in operating costs during the regulatory control period that the Commission considers Scottish Water cannot influence. The assessment at this stage takes no account of future improvements in efficiency, as these are considered separately.

Scottish Water's claim for additions to its baseline operating costs

Table 6.3 sets out Scottish Water's claim. It acknowledges that some of the increases that it claims are uncertain, and the claim is shown as broken down by Scottish Water into 'certain' and 'uncertain' items.

Table 6.3: Scottish Water's claim for additions to future baseline operating costs (2007-08 prices)

Item	Claimed increase above the baseline for 2007-08					
	Current regulatory control period		Future regulatory control period			
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
'Certain' items						
Non-domestic rates	£2.1m	£3.5m	£3.5m	£3.5m	£3.5m	£3.5m
Pensions	£1.3m	£1.7m	£2.1m	£2.7m	£2.7m	£2.7m
Odour code of practice	£1.0m	£1.0m	£1.0m	£1.0m	£1.0m	£1.0m
SEPA charges	£0.3m	£0.6m	£1.0m	£1.0m	£1.0m	£1.0m
Landfill tax	£0.1m	£0.2m	£0.3m	£0.3m	£0.3m	£0.3m
Sub-total 'certain' items	£4.8m	£7.0m	£7.9m	£8.5m	£8.5m	£8.5m
'Uncertain' items						
Non-domestic rates	-	-	£10.4m	£11.0m	£11.7m	£12.4m
Pensions	-	-	-	-	£0.7m	£1.4m
Sub-total 'uncertain' items	-	-	£10.4m	£11.0m	£12.4m	£13.8m
Other items						
Wholesale revenue management	£2.5m	£2.5m	£2.5m	£2.5m	£2.5m	£2.5m
Bad debt	-	£0.2m	£0.4m	£0.6m	£1.0m	£1.4m
Total	£7.3m	£9.7m	£21.2m	£22.6m	£24.4m	£26.2m

The largest item in Scottish Water's claim is for its projected increase in non-domestic business rates. The amounts paid by Scottish Water and other businesses depend on three factors: the rateable value (determined by the Scottish Assessors

Association), the Uniform Business Rate, and the level of any applicable relief. Scottish Water acknowledges that these factors are uncertain from 2010. It draws on both draft information from current revaluations of water companies' property in England and Wales and previous experience from similar revaluations (in England and Wales) that came into effect in 2005.

Scottish Water provided calculations in support of its claim and the Commission considered the evidence. It notes that Scottish Water made similar claims in the last price review that have since been shown to have been overstated. The Commission also notes that over the long term non-domestic business rates bills for the water and sewerage companies in England and Wales have not increased in real terms². It therefore considers that it would be inappropriate to allow for Scottish Water's uncertain claim in this determination. In the event that Scottish Water faces significant increases in rates, it may later become necessary to adjust charges through an interim determination.

The Commission's conclusions on additions to future baseline operating costs

The Commission reviewed Scottish Water's evidence in support of its claims for pension contributions, SEPA charges, odour code of practice, landfill tax, bad debt and wholesale revenue management. It considers that Scottish Water's evidence for increases in rates and pension contributions (where it regards these as 'certain') warrants an allowance. However, it concludes that there should be no allowance for 'uncertain' claimed increases in these costs. The Commission accepts Scottish Water's claim for increases in SEPA charges. It agrees that compliance with the statutory code of practice on odour control at waste water treatment works warrants the additional £1.0 million per year claimed. It agrees with the minor claim for landfill tax.

A review of Scottish Water's evidence on bad debt leads the Commission to conclude that recent improvements in the collection levels by local authorities are not yet fully reflected in current levels of debt write-off by Scottish Water. Despite current economic conditions, the Commission considers that no allowance for increased bad debt is justifiable. On wholesale revenue management, the Commission recognises that there is a cost to Scottish Water of managing its relationship with licensed retailers and the Central Market Agency. However, it considers that the level of cost claimed by Scottish Water is excessive.

The Commission's conclusions are summarised in Table 6.4. The allowance begins in 2010-11, the first year of the next regulatory control period. Efficiencies on these additions are considered later in this paper.

² An analysis by Reckon LLP 'PR09 Scope for efficiency studies', report for Ofwat, October 2008, pages 34-35 shows that business rates paid by the water companies in England and Wales decreased on average by 0.8% per year from 1992-93 to 2006-07.

Table 6.4: Allowed for additions to future baseline operating costs, before efficiencies (2007-08 prices)³

Item	2010-11	2011-12	2012-13	2013-14
Non-domestic rates	£2.9m	£2.9m	£2.9m	£2.9m
Pensions	£1.3m	£1.9m	£1.9m	£1.9m
SEPA charges	£1.0m	£1.0m	£1.0m	£1.0m
Landfill tax	£0.3m	£0.3m	£0.3m	£0.3m
Wholesale revenue management	£1.0m	£1.0m	£1.0m	£1.0m
Bad debt	-	-	-	-
Total	£6.5m	£7.1m	£7.1m	£7.1m

6.6 Initial assessed scope for efficiency in Scottish Water's baseline operating costs

The three approaches to benchmarking produce similar initial results, indicating that Scottish Water's operating costs would need to reduce by some 12% if it were to perform at upper quartile efficiency. Table 6.5 summarises the assessment before adjustments are made for special factors and the scope of activities.

Table 6.5: Initial assessment of the scope for efficiency in Scottish Water's operating cost baseline, before adjustments

Econometric model	Upper quartile efficiency challenge		
	Water	Wastewater	Total
Ofwat model	7%	18%	12%
Ofwat model extended to Scotland	9%	16%	12%
WICS alternative model	10%	14%	12%

6.7 Adjustments for scope of activities and special factors

The assessment process considers in detail to what extent the initial results should be adjusted to take account of Scottish factors. It is important that the challenge that is set for Scottish Water should be based on fully like-for-like comparisons and should distinguish costs that its managers can influence or control from those that are driven purely by external factors. The Commission asked Scottish Water to provide its own assessment as part of its business plan. This assessment was revised carefully, but in coming to conclusions the Commission also considered wider information that does not always support Scottish Water's case.

Scottish Water's claim for special factor and scope adjustments

Table 6.6 summarises Scottish Water's assessment for the amount of adjustment that it considered should be applied to the results of econometric benchmarking.

³ The costs associated with the Odour code of practice are considered later in this paper.

Table 6.6: Special factors and scope adjustment claimed by Scottish Water (2007-08 prices)

Special factors	Value
Bad debt	£13.3m
Cryptosporidium	£1.5m
Electricity	£1.8m
Public septic tanks	£1.2m
Sewer laterals	£7.2m
Supply of chemicals	£0.3m
Travel	£8.8m
Total special factors	£34.0m
Scope adjustments:	
Household metering	-£6.3m
Net special factors	£27.7m

Bad debt, travel and sewer laterals are the largest items comprising Scottish Water's claim for special factors. The basis of Scottish Water's bad debt claim is that companies in England and Wales can control bad debt by having responsibility for billing and collecting household charges. However, in Scotland, local authorities collect household charges on behalf of Scottish Water. Scottish Water considers that its indirect control over revenue collection results in higher than average bad debt costs. Scottish Water also considers that it incurs higher travelling costs in comparison to the companies in England and Wales as a result of the geography and population density of Scotland. Furthermore, Scottish Water has responsibility over lateral sewers, whereas companies in England and Wales are only responsible for certain lateral sewers; this is due to a difference in legislation between Scotland and England and Wales. This responsibility results in Scottish Water incurring operating costs on lateral sewers.

Review of Scottish Water's claim for special factor and scope adjustments

The Commission understands Scottish Water's calculations supporting its special factor claim and considered the evidence carefully. In Scottish Water's bad debt claim, its household bad debt is compared with the level of bad debt that could be achieved at average household collection levels of companies in England and Wales. Scottish Water uses household bad debt and billing and collection costs, supplied on a confidential basis, from a sample of companies in England and Wales to estimate its claim. The Commission notes that Scottish Water's sample excludes some companies that have higher than average bad debt costs. It also notes that the costs Scottish Water used in the models are different to the costs used to calculate the value of its special factor claim. The assessment corrects for this by assessing the size of the special factor claim on a vertically integrated basis, to ensure that there is consistency between the models and the special factor.

Scottish Water estimates its claim for travel as the additional travel costs it incurs over a sub-area of Scotland; it argues that this area is comparable to an average

company in England and Wales. Scottish Water adjusts for overheads in its assessment of the value of labour time lost; however, Scottish Water does not demonstrate that it incurs higher overheads due to the characteristics of its operating environment. The assessment also considers the travel costs of serving customers connected to the water system.

Scottish Water does not have information on the cost of operating lateral sewers. However, Scottish Water estimates its operating costs using lateral sewer length and the number of call-outs. The Commission considers that there is inherent bias in this approach. Instead, it uses independent third party information⁴ on the costs of operating lateral sewers and adjusts for Scottish Water.

The costs in Scottish Water's electricity special factor claim are different to the costs that it incurs. The Commission also considers that the econometric models account for Scottish Water's higher cost of procuring chemicals. A scope adjustment has also been included to account for the companies in England and Wales undertaking non-cryptosporidium sampling activity far in excess of Scottish Water.

Conclusions on the level of special factor claims and scope adjustments to allow for

Table 6.7 summarises the conclusions on the adjustments for special factors and scope of activities to allow for in charges.

Table 6.7: Conclusions on the adjustments for special factors and scope of activities to allow for in charges (2007-08 prices)

Item	Scottish Water's claim	Proposed allowance
Special factors:		
Bad debt	£13.3m	£5.4m
Cryptosporidium	£1.5m	£1.2m
Electricity	£1.8m	-
Public septic tanks	£1.2m	£1.2m
Sewer laterals	£7.2m	£4.9m
Supply of chemicals	£0.3m	-
Travel	£8.8m	£7.0m
Total special factors	£34.0m	£19.8m
Scope adjustments:		
Household metering	-£6.3m	-£6.3m
Sampling activity		-£1.6m
Net special factors	£27.7m	£11.9m

⁴ 'Impact Assessment of transfer of private sewers and lateral drains to statutory water and sewerage companies', DEFRA, November 2008.

The adjustments for special factors and scope of activities that the Commission proposes to allow for reduce slightly the assessment of the scope for efficiency improvements. Table 6.8 sets out the revised assessments.

Table 6.8: Assessment of the scope for efficiency improvement, after adjustments for special factors and scope of activities

Econometric model	Upper quartile efficiency challenge		
	Water	Wastewater	Total
Ofwat model	8%	12%	10%
Ofwat model extended to Scotland	10%	11%	10%
WICS alternative model	9%	10%	10%

6.8 Conclusions on the operating cost baseline after efficiency improvement

The Commission concludes that Scottish Water should be able to achieve a baseline of operating costs of around £250 million by 2013-14, if it achieves upper quartile performance. This comprises its baseline in 2007-08 of around £270 million (Table 6.2) plus around £7 million additions to that baseline (Table 6.4) less around 10% efficiency (Table 6.8).

6.9 Assessment of the scope to improve levels of service performance

The Commission considered the levels of service performance information from England and Wales, and Scottish Water's current performance. It concluded that Scottish Water has scope to achieve and outperform upper quartile performance levels in England and Wales.

Many of the ten water and sewerage companies in England and Wales achieve consistently high levels of performance on Ofwat's OPA measure. Table 6.9 sets out the scores achieved in 2007-08 by the better performing companies⁵.

Table 6.9: OPA scores achieved by the better performing companies in 2007-08

Company	OPA performance in 2007-08
Anglian Water	402
Wessex Water	400
Yorkshire Water	389
Thames Water	380
Dŵr Cymru	375
Southern Water	374

⁵ The OPA scores presented here are calculated using the components listed in Table 6.1, which represents the proposed framework for the next regulatory control period. The components cover a wider range of levels of service than are covered in Scottish Water's current OPA and in Ofwat's current published OPA scores for the water and sewerage companies.

In its business plan, Scottish Water assessed upper quartile performance as 389 OPA points. It indicated that it could achieve 387 points by 2013-14 and 389 points by 2015-16, provided that it was not penalised by possible non-compliance at one of its large waste water treatment plants, Dalmuir, which is operated under a public private partnership. It therefore requested that performance at Dalmuir be formally excluded from the annual assessment of OPA. The Commission considered this request carefully, but is not persuaded that a determined management would be unable to secure compliance at such a works. It concluded that a challenge to increase Scottish Water's OPA score to upper quartile levels by 2013-14 is appropriate and achievable.

Upper quartile performance is defined as the mean score of the second and third placed companies. This would indicate a figure of around 394 in 2007-08. Scottish Water stated in its business plan that company OPA performance can vary from one year to another. Whilst the Commission accepts that there is some variation, the mean of the second and third placed companies has, according to Scottish Water's analysis, remained at or above 389 in each of the last five years, on a like-for-like basis. However, the Commission understands Scottish Water's argument and therefore proposes that it achieves a score of 389 points by 2013-14.

The Commission notes that the maximum achievable OPA score is almost 419 points. It considers that Scottish Water therefore has scope to outperform the challenge. The Commission also considers that in the event that there is a five-year regulatory control period, Scottish Water should achieve a score of 400 by 2014-15, which is equal to the second placed company in 2007-08.

The proposed improvements in Scottish Water's levels of service to customers represent a significant challenge that is likely to require determined management. The proposals would require Scottish Water to increase its OPA by around 100 points from a forecast 291 points in 2009-10.

In its business plan, Scottish Water indicated that it would absorb fully, by 2013-14, the additional costs of improving its levels of service performance. The Commission agrees that this is appropriate and, according to the benchmarking, is consistent with upper quartile performance in both levels of service and operating costs.

Table 6.10 sets out Scottish Water's claim for additional operating expenditure necessary to achieve an OPA score consistent with upper quartile performance of the companies in England and Wales.

Table 6.10: Scottish Water’s claim for additional operating expenditure required to achieve upper quartile performance on the OPA score (2007-08 prices)

	Current regulatory control period		Next regulatory control period			
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
OPA related operating expenditure	£0.7m	£1.8m	£6.4m	£7.3m	£8.3m	£8.8m
OPA related operating expenditure absorbed	-	-	£1.6m	£3.7m	£6.2m	£8.8m
Net OPA related operating expenditure	£0.7m	£1.8m	£4.8m	£3.6m	£2.1m	-

6.10 New operating costs

The Commission proposes to allow for an efficient level of net new operating costs to deliver the objectives of the Scottish Government. It also proposes to allow for the costs of a number of additional outputs that it considers are in the interests of customers.

Scottish Water’s claim for new operating costs

In its business plan, Scottish Water set out its claim for net additional new operating costs that would result from meeting the objectives of the Scottish Government. These objectives are associated with three Quality and Standards investment programmes, 2, 3a and 3b, covering the periods 2002-03 to 2005-06, 2006-07 to 2009-10 and 2010-11 to 2013-14, respectively. The claim covers net additional costs over and above those incurred in 2007-08. Delays in completing Quality and Standards 2 mean that some new costs arising from this programme fall after 2007-08.

Scottish Water’s claim distinguishes between costs to meet the requirements of new legislation and costs of improvements to levels of service that were required by the Scottish Government, and which affect Scottish Water’s OPA score. Scottish Water also identifies its estimated net operating costs associated with reducing leakage.

Table 6.11 sets out Scottish Water’s claim.

Table 6.11: Scottish Water’s claim for net new operating costs, before efficiencies (2007-08 prices)

Item	Current regulatory control period		Next regulatory control Period			
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Quality and Standards 2	£0.1m	£0.3m	£0.3m	£0.3m	£0.3m	£0.3m
Quality and Standards 3a	£1.4m	£3.7m	£5.2m	£5.4m	£5.5m	£5.5m
Quality and Standards 3b	-	-	£0.1m	£1.5m	£4.9m	£6.9m
Leakage reduction	£3.8m	£3.2m	£1.4m	£0.9m	£0.7m	-£0.2m
Net total	£5.3m	£7.2m	£7.0m	£8.1m	£11.4m	£12.5m

In its business plan, Scottish Water proposes to absorb the costs of OPA improvement and leakage reduction by 2013-14 and to deliver efficiencies in the costs of meeting new legislative requirements.

Conclusions on new operating costs

The Commission has reviewed Scottish Water’s claim in detail. It agrees with Scottish Water that it would be appropriate to absorb the operating costs of improvements to levels of service, including leakage reduction.

Table 6.12 summarises the Commission’s conclusions on the level of new operating costs to allow for.

Table 6.12: Conclusions on new operating costs (2007-08 prices)

Item	2010-11	2011-12	2012-13	2013-14
Quality and Standards 2	£0.3m	£0.3m	£0.3m	£0.3m
Quality and Standards 3a	£5.2m	£5.4m	£5.5m	£5.5m
Quality and Standards 3b	£0.1m	£1.5m	£4.9m	£6.9m
Leakage reduction	-	-	-	-
Net total	£5.6m	£7.2m	£10.7m	£12.7m

However, the Commission considers that Scottish Water’s assessment of the costs of meeting new legislation under Quality and Standards 3b may underestimate the full extent of the challenge that it faces over the next regulatory control period. The Commission identified new activities that are not covered in Scottish Water’s business plan but which it believes should be undertaken in the interests of customers.

It proposes to allow for additional annual operating costs of up to £10 million. These would cover:

- a three year metering trial for household premises;
- working with stakeholders in five water catchment areas that may be resource constrained or where more proactive work with local landowners is required;
- improving regulatory reporting;
- providing information to help licensed retailers and their customers to identify potential savings in water supply and distribution and waste water transport and treatment;
- contributing to the costs of the Central Market Agency;
- controlling odour at high and medium risk waste water treatment works;
- additional retail competition; and
- working to reduce the risk of cryptosporidium in five lower risk catchments, to be agreed with the DWQR.

Table 6.13 sets out the costs that the Commission proposes to allow for.

Table 6.13: Additional proposed operating costs (2007-08 prices)

Item	2010-11	2011-12	2012-13	2013-14
Household metering trial	-	£1.0m	£1.0m	£1.0m
Working with stakeholders in five vulnerable catchment areas	£2.0m	£2.0m	£2.0m	£2.0m
Improve regulatory reporting	£2.5m	£2.5m	£2.5m	£2.5m
Providing information to help licensed retailers and their customers	£1.0m	£1.0m	£1.0m	£1.0m
Contribution to Central Market Agency costs	£1.0m	£1.0m	£1.0m	£1.0m
Controlling odour at high and medium risk sites	£1.0m	£1.0m	£1.0m	£1.0m
Additional retail competition	£0.5m	£0.5m	£0.5m	£0.5m
Reduce the risk of cryptosporidium in five lower risk catchments	£1.0m	£1.0m	£1.0m	£1.0m
Total	£9.0m	£10.0m	£10.0m	£10.0m

6.11 Allowed for operating costs

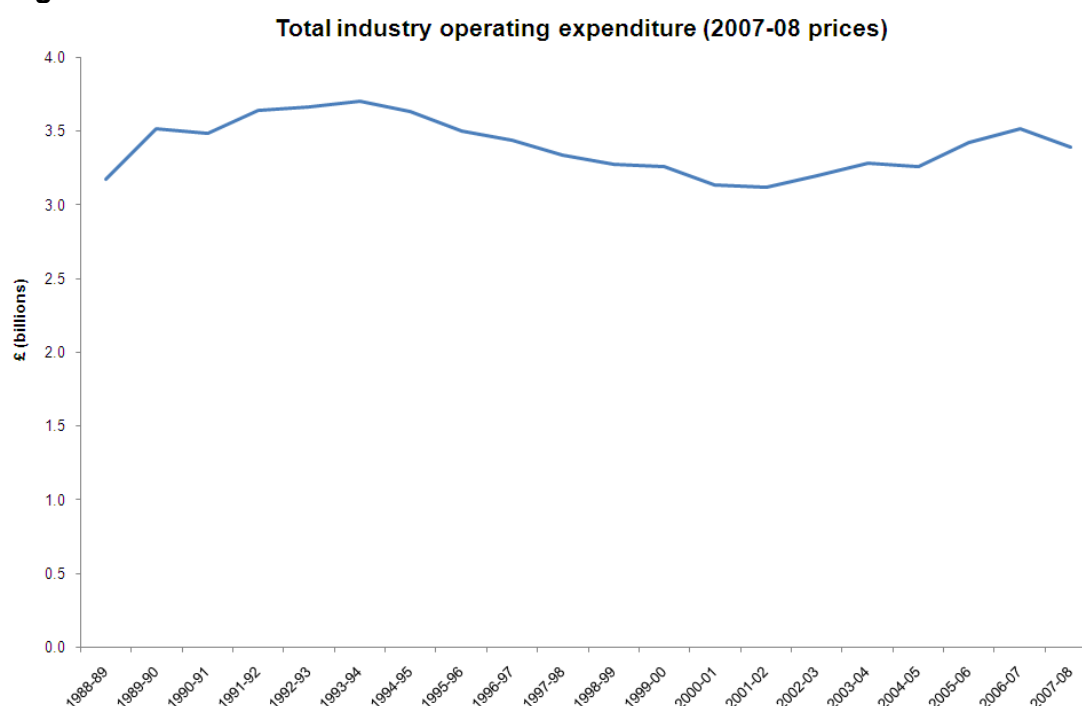
Table 6.14 summarises the operating costs that the Commission proposes to allow for during the next regulatory control period.

Table 6.14: Summary of proposed operating costs (2007-08 prices)

Item	2010-11	2011-12	2012-13	2013-14
Baseline	£270.0m	£270.0m	£270.0m	£270.0m
Additions to baseline	£6.5m	£7.1m	£7.1m	£7.1m
Efficiencies on baseline	-£6.9m	-£14.1m	-£21.4m	-£28.9m
OPA	£4.8m	£3.6m	£2.1m	-
New	£5.6m	£7.2m	£10.7m	£12.7m
Efficiencies on new	-£0.1m	-£0.3m	-£0.9m	-£1.3m
Additional items	£9.0m	£10.0m	£10.0m	£10.0m
Total	£288.8m	£283.5m	£277.6m	£269.6m

However, the evidence of past performance by companies in England and Wales suggests that over the medium term operating costs tend to remain broadly flat. This is illustrated in Figure 6.3.

Figure 6.3: Total water and sewerage industry operating expenditure in England and Wales



Efficiency improvements manifest themselves more through the delivery of better levels of service rather than as cost reductions. The Commission considers that the challenge for Scottish Water should be framed in line with this evidence. It therefore proposes to allow for £280 million per year of operating costs, taking the baseline of £270 million in 2007-08 and allowing for £10 million per year of additional costs. This

level should challenge Scottish Water to deliver efficiencies early in the next regulatory control period, as it is important that Scottish Water maintains a focus on costs. However, the Commission's proposal would appear to allow Scottish Water scope to outperform over the period as a whole. The proposed allowance would be the same in real terms in the event of a five-year regulatory control period.

6.12 Summary

The Commission proposes that Scottish Water should achieve upper quartile performance in both levels of service and operating costs by 2013-14. The benchmarking assessments indicate that Scottish Water faces a significant challenge in delivering this level of performance, which will require a determined management to succeed.

The level of operating costs that the Commission proposes to allow for is £280 million for each year of the next regulatory control period. The Commission considers that this should allow Scottish Water scope to outperform over the regulatory control period, whilst maintaining current management focus on controlling costs.