

Water Industry Commissioner for Scotland

COST BASE

An independent review of the Cost Base as applied to Scotland

Executive Summary

30 June 2005

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Prepared by: Approved by:

Andrew Selby
Associate Director

Nigel Jones
Specialist Consultant

Keith Brown
Regional Director

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Telephone: 020 8784 5784
Fax: 020 8784 5700
Website: <http://www.fabermaunsell.com>

Marlborough House
Upper Marlborough Road
St Albans
Hertfordshire AL1 3UT

Section 1: Executive Summary

1. Executive Summary

The Water Industry Commissioner for Scotland (WICS) is undertaking a price review of Scottish Water for the period 2006 to 2010. WICS has applied the Ofwat Cost Base methodology for assessing the scope for efficiencies in Scottish Water's capital investment proposals. The Cost Base process has been applied to company submissions in England and Wales for the last three price reviews.

The Cost Base process requires Scottish Water to submit Standard Costs for a range of activities included in its Investment Plan proposals. The scope of these defined Standard Costs is the same as applied by Ofwat to companies in England and Wales for the 2004 Periodic Review. Ofwat required company submissions to be subject to scrutiny by the respective Reporters. Ofwat also engaged independent consultants to review the completeness, compliance and consistency of submissions with the reporting requirements, and to establish industry benchmarks.

Faber Maunsell was engaged by WICS to undertake an independent review of the methodology as applied in Scotland to ensure completeness, compliance and consistency with the Ofwat process. The one difference was we were not required to review the benchmark selection process as WICS applied the Ofwat benchmarks.

We undertook a document review and held meetings with Ofwat and its consultants to obtain a detailed understanding of the process and how it had been applied in England and Wales. We confirmed that the Cost Base process has been applied by WICS in a manner consistent with the Ofwat process in that:

- (i) The same set of reporting requirements and Standard Cost definitions were used by WICS and Ofwat;
- (ii) The same process of independent review and challenge was carried out by Faber Maunsell and Babbie;
- (iii) Reliance was placed on the Reporter's role in challenging Scottish Water's submissions, confirming the basis of the Standard Costs presented and commenting on any material concerns such as data sources, methodology, assumptions and compliance with definitions;
- (iv) Close scrutiny was placed on compliance with the Standard Cost definitions;
- (v) A documented query process was established. We raised queries with Scottish Water, WICS and Ofwat. We raised more queries than Ofwat through the process, as this was the first time that Scottish Water had made a submission subject to Reporter and independent review. We were concerned to ensure compliance with the definitions and consistency of approach;
- (vi) The process of draft and final submissions of the Cost Base information allowed Scottish Water to respond to comments by the Reporter and our queries. The changes in the final submission in May 2005 compared with earlier submissions in February and April, reflects this process;
- (vii) Our review process has been clearly documented at each stage and subject to close quality control. The supporting documents included in the appendices clearly show all the stages of this review;
- (viii) Our methodology and independent assessments have been subject to peer review by SMC and Ofwat.

We found that while many Standard Costs submitted by Scottish Water had raised comments by the Reporter and ourselves, we focussed on those Standard Costs, which had a material impact on the analysis.

There are 124 Standard Costs within the Cost Base Process. Scottish Water submitted 101 Standard Costs in its final submission in May 2005. We endorsed 90 Standard Costs, two were not endorsed but not material, and nine were material and subject to expert review. This enabled 95 Standard Costs to be used in the Cost Base modelling by WICS to support capital efficiency assessments; six Standard Costs submitted by Scottish Water were for activities where Ofwat were not able to generate a benchmark because of the limited data points or wide spread of data.

We identified, from our review and Reporter comments, some shortcomings in Scottish Water's methods and processes, which need to be addressed in future submissions. In particular we found that the

methodology applied and values derived for on-costs were complicated and confusing. This was clarified in part by the query process. However, our view is that there are important issues of data quality, a lack of auditable methodology and processes, which remain unresolved. The process of deriving company specific costs and, in the case of Scottish Water, regional variations in costs across the country is unclear. We concluded that we were unlikely to resolve these issues within the timescale of this process.

The Cost Base process asks Scottish Water to apportion investment to each Standard Cost or groups of Standard Costs. The proportions have been adjusted by WICS to reflect its view on the scope and extent of the investment programme following a detailed review¹.

There are areas of expenditure in the Scottish Water Investment Plan, which are not addressed by the Cost Base process such as water resources, sludge treatment and management and general expenditure on both services, which when combined represent 21% of water and 17% of sewerage expenditure respectively (using WICS proportion of expenditure).

We are grateful for the assistance provided by Ofwat, Babbie, Scottish Water, Black and Veatch and WICS in undertaking this independent review.

Opinion

We conclude that WICS has successfully implemented a Cost Base process which is consistent with the Ofwat process in England and Wales (E&W). The Standard Costs submitted provide a substantial coverage of Scottish Water's Investment Plan. While there is scope to improve the clarity and auditability of data and methodologies by Scottish Water, this does not invalidate the comparisons with E&W benchmark companies and the range of data points. Equally, Scottish Water data can be used with confidence for comparisons in England and Wales. There are 95 Standard Costs that can be compared on this basis.

¹ *Water Industry Commissioner for Scotland: Scottish Water Investment Review – A review of the Scottish Water Q&SIII Investment Programme, as contained within Scottish Water's 2nd Draft Business Plan – Main Report June 2005. Faber Maunsell*

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