

Stakeholder workshop 7: Scottish Water's operating costs

Why are Scottish Water's operating costs important to customers?

Scottish Water incurs operating costs from the day-to-day running of its business. Operating costs include for example employment costs, electricity, fuel, chemicals, charges raised by SEPA and business rates. Operating costs do not include the costs of investing in assets, the costs of maintaining assets or financing costs. Operating costs comprise a significant component of Scottish Water's overall expenditure. In 2005-06, Scottish Water's operating costs represented around a quarter of its overall costs.

As a significant component of Scottish Water's overall costs, operating costs can have a material impact on the outcome of the price review. All else remaining the same, the higher Scottish Water's operating costs are, the higher price caps will be. However, without sufficient allowance for operating costs, Scottish Water may not be able to fulfil its core duties. We have a statutory duty to set charge caps consistent with delivering Ministers' objectives at the "lowest reasonable overall cost". It is therefore important that prices allow for sufficient operating costs for Scottish Water to run its business effectively, and to a standard consistent with Ministers' objectives, but no more.

Stakeholders' views at the last workshop

We held our first workshop on Scottish Water's operating expenditure on 31 May 2007. This workshop set out the main issues we were considering consulting on, and sought stakeholders' views. Attendees at the workshop raised a number of issues, but discussion primarily concentrated on the relationship between levels of service and operating costs, by how much Scottish Water should be expected to improve its efficiency and the econometric modelling we use to benchmark efficiency.

Attendees recognised that there was a trade off between levels of service and costs. It was questioned whether evidence existed to suggest that customers wished to pay more for a better level of service, and if so, which elements of service?

Attendees discussed our use of Ofwat's overall performance assessment to measure Scottish Water's levels of service. Attendees questioned whether the OPA encouraged the correct behaviours from Scottish Water – did it encourage continuous improvement in levels of service, or did it serve to encourage Scottish Water to embed its existing performance? Furthermore, attendees questioned whether, by using the OPA, it was reasonable to assume that customers' preferences regarding levels of service were the same north and south of the border – did they attach the same importance to the elements of service that comprise the OPA?

Attendees discussed how Scottish Water's operating cost efficiency compared with the companies in England and Wales. Attendees recognised that during the 2010-14 period, companies in England and Wales would be required to improve their performance. Should Scottish Water be required to follow suit and become a frontier company, or is it unreasonable to request Scottish Water to match a level of performance that has yet to be demonstrably achieved elsewhere?

Attendees discussed the econometric models we use to benchmark Scottish Water's operating cost efficiency. It was noted that the models were something of a 'black art', and were not always transparent for stakeholders.

The issues we are consulting on

On 28 June, we published Volume 3 of our methodology consultation. We are seeking stakeholders' views on the following issues:

Do respondents agree that our approach to benchmarking Scottish Water's performance remains robust despite the separation of non-household retail activities in Scotland?

Since the last price review, Scottish Water has created a separate entity to provide retail services to non-household customers. It is important that we continue to make like-for-like comparisons with the English and Welsh companies. We therefore need to take account of Scottish Water's change in structure in our efficiency assessment. We have identified two ways in which we could do this: 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.

Do respondents agree that we should take account of differences in the level of service and scope of activities in Scotland and England and Wales?

When we use econometric models to compare Scottish Water's efficiency with the English and Welsh companies we assume that they offer the same range and level of service. This is because in England and Wales there is little material difference between the levels of service offered by companies. However, whilst Scottish Water is improving levels of service, according to its OPA score, its performance is still not as good as the English and Welsh companies. By taking into account this difference, that is, recognising that Scottish Water is delivering fewer outputs for its expenditure, will we take a more accurate view of Scottish Water's efficiency? Is it reasonable to do so?

Do respondents agree with our favoured approach to setting an appropriate efficiency challenge for Scottish Water?

If Scottish Water is not yet as efficient as the companies in England and Wales, should it be set further targets to improve? We believe it should – but by how much? We propose that Scottish Water should be challenged to deliver an equivalent level of service for an equivalent level of cost as the leading water and sewerage companies in England and Wales during 2007-08. This challenge does not take into account how the English and Welsh companies may improve during 2010-14, that is, it will not take Scottish Water to the frontier. However, it is a level of performance that the English and Welsh companies have demonstrated can be achieved. In the interests of customers, is this too great or too less a challenge?

Do respondents agree that our approach to assessing claims for special factors is reasonable?

We recognise that there could be differences in Scottish Water's circumstances compared with the England and Welsh companies that are beyond its control and that affect its costs. Such factors may increase or decrease costs. It is important that if we are to make like-for-like comparisons we take such differences into account. We propose asking Scottish Water to provide evidence of the existence and impact on costs of these 'special factors'.