

Workshop

Stakeholder workshop 7: Scottish Water's operating costs

Strategic Review of Charges 2010-14: Methodology
Edinburgh, 30 August 2007



The price review process focuses on delivering value for money for customers. The process can be summarised in three high level steps....

1. Ministers set objectives for the industry over the regulatory control period, and define the principles of charging that must be followed.
2. Scottish Water proposes how it will deliver these objectives, and the financing it will need to do so.
3. We scrutinise Scottish Water's proposals and set final caps on prices that finance Scottish Water to deliver the Ministers' objectives at the lowest overall reasonable cost.

Although in practice, the process involves a number of interim stages to allow for consultation and many more stakeholders!

This process has already begun. There are just 27 months to go...

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|---|----------------------|
| Methodology consultation published | 10 May –26 July 2007 |
| Methodology consultation period closes | 19 October 2007 |
| SW submits first draft business plan | 30 May 2008 |
| Ministers issue guidance | 30 September 2008 |
| SW submits second draft business plan | 13 March 2009 |
| Draft determination of price limits published | 30 June 2009 |
| Draft determination consultation closes | 23 September 2009 |
| Ministers issue directions | 23 September 2009 |
| Final determination of price limits published | 30 November 2009 |

We welcome stakeholders' views. We are offering stakeholders a number of opportunities to influence and scrutinise our contribution to the price review.

These opportunities include:

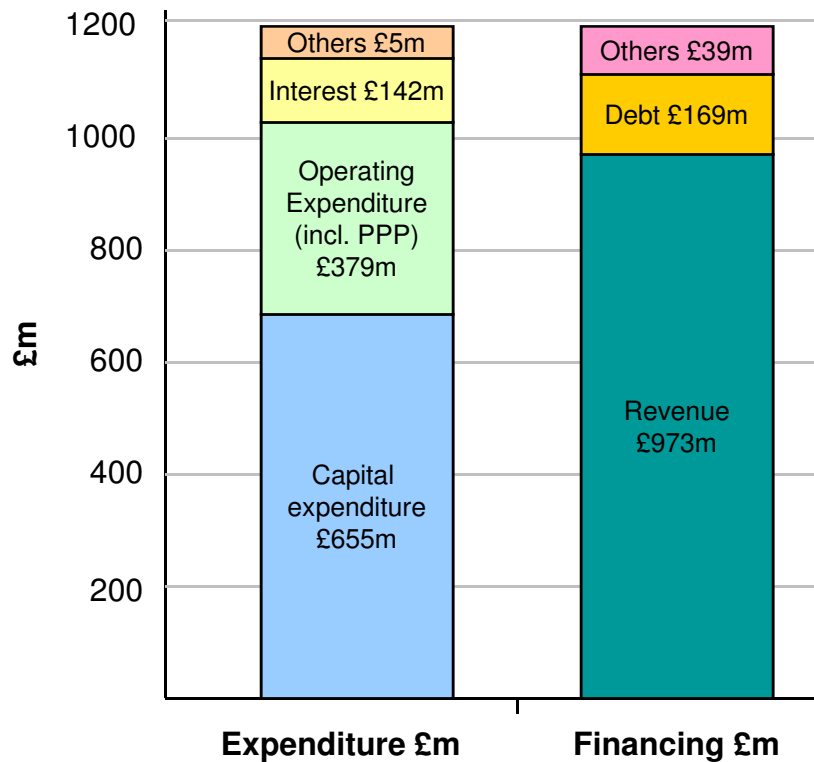
- A formal consultation on our overall approach (issued last December)
- 8 stakeholder workshops on our methodology
- A formal methodology consultation
- 8 further stakeholder workshops on our draft determination of charges
- A 12 week period to make formal representations on the draft determination of charges

Our methodology consultation focuses on 4 key areas. Our workshops also follow this pattern.

- The methodology consultation was published in 4 volumes during May, June and July.
- For each volume we are holding two workshops for stakeholders.

| Volume | Publication date | Workshops |
|---|------------------|-----------------------------------|
| 1. Financing Scottish Water | 10 May 2007 | 12 April 2007 26 July 2007 |
| 2. Customer revenue and levels of service | 31 May 2007 | 10 May 2007 16 August 2007 |
| 3. Operating costs | 28 June 2007 | 31 May 2007 Today |
| 4. Capital expenditure | 26 July 2007 | 28 June 2007 20 September 2007 |

Operating expenditure (opex) is an important component of Scottish Water's overall expenditure...



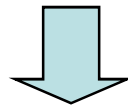
In 2005-06, operating expenditure represented c.32% of Scottish Water's overall expenditure.

Scottish Water's operating expenditure covers, for example, employment costs, electricity, fuel, chemicals etc.

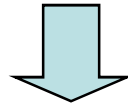
Over the 2002-06 regulatory control period, Scottish Water reduced its operating costs by 40% (just over £3 million a week)

In a price review, we need to allow Scottish Water sufficient operating expenditure (opex), but no more than necessary. We approach this by....

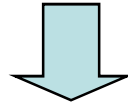
Assessing baseline opex (in a given “base year”).



Predicting and adjusting for future changes to the baseline. For instance, increases in pension contributions.



Allowing for new operating expenditure which is consistent with the investment programme.



Making an efficiency adjustment by comparing Scottish Water’s opex and the service it provides with the English and Welsh companies. We allow for specific differences in circumstances which affect this comparison.

Volume 3 of the methodology consultation poses the following questions about our approach...

1. Do respondents agree that our approach to benchmarking Scottish Water's performance remains robust despite separation of non-household retail activities?
2. Do respondents agree that we should take account of differences in the level of service and scope of activities in Scotland and in England and Wales?
3. Do respondents agree with our favoured approach to setting an appropriate efficiency challenge for Scottish Water?
4. Do respondents agree that our approach to assessing claims for special factors is reasonable?

1. Competition: the introduction of competition will affect how we make comparisons with England and Wales...

Scottish Water will no longer be responsible for retail services to non-household customers. We need to ensure that we continue to compare like with like.

In Volume 3, we suggest we can take account of this change in one of two ways:

- By deducting comparable “retail” costs from the English and Welsh companies; **or**
- By adding back the operating costs incurred by Scottish Water Business Stream to Scottish Water’s total operating costs.

2. Levels of service: when we make efficiency assessments, we need to consider both the costs incurred, and the service provided...

Though improving, Scottish Water is not yet providing the same level of service as the English and Welsh companies. This affects our assessment of Scottish Water's comparative efficiency.

- Should we take account of this difference?
- If so, how should we take account of this difference?
- Should we set targets for Scottish Water to improve its levels of service? Would this take full account of the difference?
- Or, should we seek to understand the costs that would be involved in improving service?

3. Efficiency challenge: We anticipate Scottish Water will not yet be as efficient as the English and Welsh companies... ...Volume 3 questions how we can encourage it to improve further.

We use the English and Welsh companies as an indicator of what Scottish Water can achieve. At the next price review, we will need to answer the following questions:

- Is it reasonable to expect Scottish Water to be as efficient as the English and Welsh companies?
- If so, which companies should we compare them with – the highest achievers, the top three, the industry mid-point?
- Should we take into account expected improvements in the companies performance during 2010-14? Or should we ask Scottish Water to perform at a level that has already been achieved in England and Wales?

4. Special factors: there may be factors, unique to Scottish Water, that affect its costs. Volume 3 proposes how we can take account of them.

There could be differences in Scottish Water's circumstances (compared with the English and Welsh companies) that are beyond its control and affect its operating costs. Such factors may increase or decrease costs.

- Is it reasonable to take these factors into account?
- We propose placing the onus on Scottish Water to demonstrate the existence of these factors, and their affect on its costs. Is this reasonable?

Thank you, we would welcome your questions