

Operating expenditure

This note gives an outline of Scottish Water's operating expenditure performance to date and our initial expectations for 2015-20.

Key messages

Over the past decade the water industry has faced upward cost pressures, and in England and Wales, operating expenditure has increased in real terms. Over the same period, Scottish Water has reduced its operating expenditure by around 40% in real terms, closing what had been a large efficiency gap.

At the last price review Scottish Water agreed to accept our challenge to match upper quartile performance of the industry before 2015. Scottish Water is restructuring its business and, to judge by latest figures, is on track to meet this challenge. We now consider it likely that Scottish Water's operating expenditure performance is on a par with that of the leading companies.

Looking beyond 2015, upward pressures on costs are likely to continue, driven in part by rising compliance standards and growth in the customer base. However these could be significantly offset by continuing improvements in efficiency. On this basis, we consider that a range for annual operating expenditure of between £320 million and £345 million (in 2011-12 prices) should be expected for the period 2015-20. This compares with £325 million in 2011-12, adjusted for one-off items.

Introduction

Operating expenditure is simply the amount a company spends on its day to day activities, as opposed to capital investment, other financing costs and taxes on profit. In order to monitor performance over time and make comparisons with water and sewerage companies on a like-for-like basis, we find it helpful to distinguish three broad categories of operating expenditure:

One-off

This is abnormal expenditure caused by factors that do not occur every year. Examples include severe weather, unusually high write-offs of unpaid customer bills, business reorganisation and redundancy costs. Sometimes the one-off impact is a saving rather than a cost, for example when there is an unusually low write-off of unpaid customer bills.

Controllable

This is normal expenditure over which companies' managers can exert direct control. Examples include salaries, energy, chemicals, communication costs, transport and office materials.

Outside direct control

Normal expenditure that is outside managers' direct control includes local authority business rates, costs incurred to divert mains or sewers at the request of highway authorities, and payments to environmental regulators for abstraction licences and effluent discharge consents.

Using these categories means that we have three versions of the expenditure figure:

- **reported** total operating expenditure – the 'headline' figure in the regulatory accounts¹;
- **underlying** operating expenditure – the reported figure less any one-off items, which is useful both for looking at trends over time and for establishing a baseline for the future; and
- **controllable** operating expenditure – the reported figure less one-off items less costs that are outside the direct control of management, which we use to level the playing field for our benchmarking with companies in England and Wales.

¹ Operating expenditure is reported in the annual audited regulatory accounts, with a detailed breakdown and commentary. There is a similar regulatory reporting and auditing regime north and south of the border.

Scottish Water’s improving performance

We have tracked the performance of Scottish Water and its predecessors since 2000 and benchmarked it with the privatised water and sewerage companies in England and Wales.

When Scottish Water was created in 2002, our benchmarking showed that underlying operating expenditure was significantly higher than it needed to be. We set Scottish Water the challenge of reducing it by 37% by 2005-06. After a slow start, it nevertheless achieved a reduction of 39% by that year. We set a further challenge in our 2005 price review, which Scottish Water also outperformed. In 2009 we set Scottish Water the challenge of matching upper quartile performance of the private water and sewerage companies in England and Wales by 2015. Scottish Water accepted, and is now on track to meet, or possibly to outperform, this challenge.

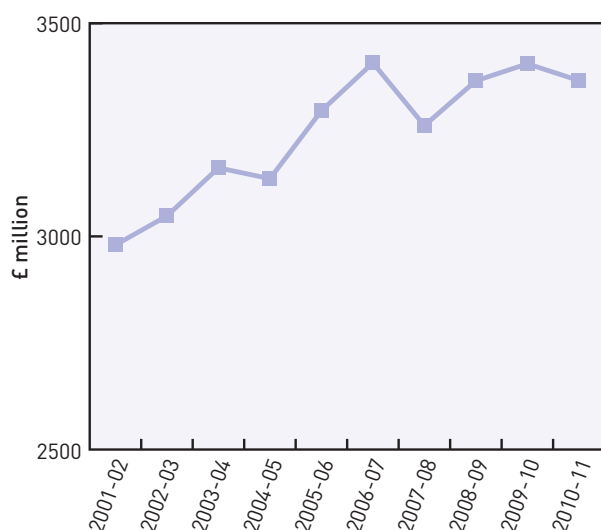
The industry as a whole has faced significant upward cost pressures, for example rising energy and bad debt costs. In England and Wales, such pressures have increased underlying operating expenditure by around 13% in real terms over the last decade.

Since 2010 Scottish Water has also faced a substantial increase in the business rates it must pay to local authorities, amounting to 6% of its annual operating expenditure. This cost is largely outside the company’s scope to influence and is therefore one of the items we exclude when benchmarking.

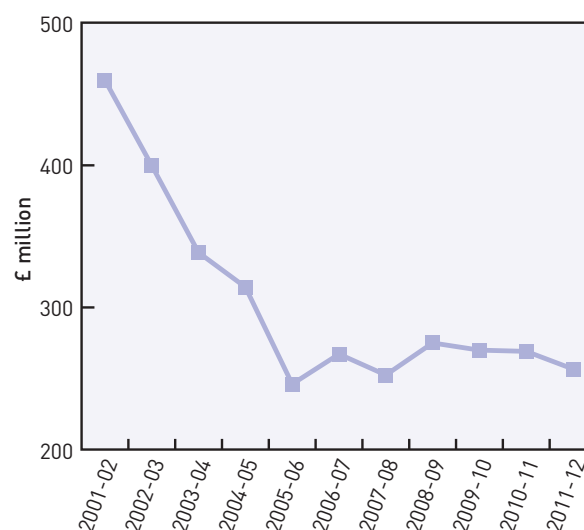
Scope for further improvement

We carried out extensive analysis of relative controllable operating expenditure for the 2009 price review, taking 2007-08 as our ‘base year’. This involved detailed benchmarking using various econometric models. We identified a 10% efficiency gap between Scottish Water and upper quartile performance in England and Wales. This benchmarking process was a major exercise and has not been repeated. However, we can analyse expenditure trends since 2007-08 in order to estimate Scottish Water’s current performance levels.

Controllable operating expenditure: England and Wales water and sewerage industry (2011-12 prices)



Controllable operating expenditure: Scottish Water (2011-12 prices)



In 2007-08 our analysis showed that Yorkshire Water was the best performing company for operating expenditure, followed by Wessex Water and Anglian Water. Recent trends in controllable expenditure indicate that these companies continued to be leading performers in 2011-12. Since 2007-08 many companies have reported substantial upward pressures on controllable operating expenditure, with the three leading companies in total reporting a 12% increase in real controllable operating expenditure. The comparable increase reported by Scottish Water is just 2%.

These recent figures can only provide a general indication of relative trends in operating expenditure efficiency. For example, companies in England and Wales became responsible for private sewers in October 2011, which may account for some of the reported increase in expenditure. Unfortunately, the companies are no longer required to submit annual regulatory returns (which explained material movements in expenditure) to Ofwat.

We consider that Scottish Water has managed its controllable operating costs and in doing so has reduced the 10% performance gap against upper quartile companies in England and Wales. Judging by these recent trends in controllable operating expenditure, we consider it unlikely that a material gap in performance still exists between Scottish Water and leading water and sewerage companies.

Prospects for operating expenditure 2015-20

Scottish Water has absorbed much of the impact of external shocks such as the increase in business rates and the effects of the severe winter weather in December 2010. It is using its strong cash position to restructure the regulated business, spending more than £25 million so far since 2009-10. Adjusting for these and other one-off costs, the company's current underlying annual operating expenditure in 2011-12 is around £325 million (in 2011-12 prices).

Scottish Water forecasts an increase in underlying operating expenditure before 2015, arising from the cost of:

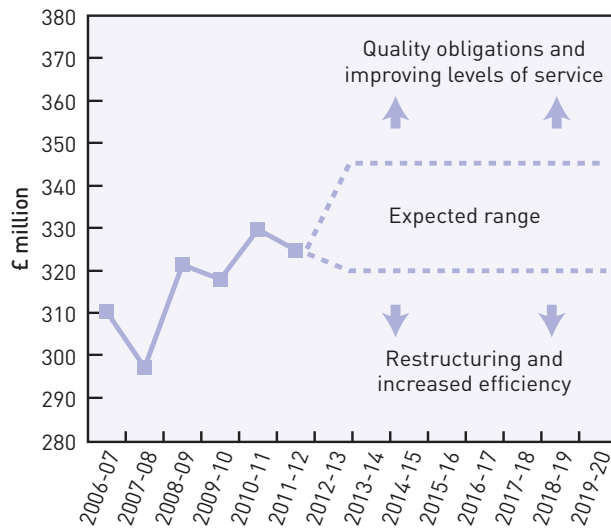
- achieving the levels of service performance score agreed for this regulatory control period²;
- operating new assets such as treatment works that it is building to deliver its statutory obligations; and
- further inflationary increases in local authority rates and energy costs.

Taken together, these pressures could add up to around £20 million to annual underlying operating expenditure by 2015. However, we consider that by that time Scottish Water's current restructuring initiative should be delivering savings in underlying annual operating expenditure of at least £5 million, to warrant its cost in excess of £25 million. Such savings would therefore offset some of Scottish Water's forecast increase.

Beyond 2015, we consider that upward pressure on operating expenditure arising from increasing standards for purifying drinking water and waste water effluent is likely to ease slightly, so that they could be offset by continuing improvements in efficiency, albeit at a slower pace than before. As a major energy user, Scottish Water may well face additional long-term cost pressures from energy prices. However, it could mitigate some of these costs through further reductions in leakage and through developing its own energy production. Like other businesses, it may face rising labour costs, which may be offset by improvements in productivity. It will also need to provide services to a growing number of customers. In the round, we consider that these various upward pressures on costs could be significantly offset by continuing improvements in efficiency.

² Notes 2 and 3 will cover levels of service.

Initial expectations for operating expenditure



A water and sewerage business will always face unexpected one-off costs from time to time. However, it would be unusual for such costs to exceed £5 million to £10 million in any one year for a business the size of Scottish Water. On average, we would not expect such costs to be more than £5 million a year. Taking these factors into account, and recognising that the balance between upward and downward cost pressures is uncertain, we consider that a range of between £320 million and £345 million (in 2011-12 prices) for annual total operating expenditure should be expected for the period 2015-20.

Points to be aware of

Our comments at this stage on the prospects for operating expenditure cannot take account of the extent to which Scottish Water chooses to implement operating cost solutions. We will outline our broad expectations in this area in Note 4.

The focus of the Commission will be on total cash outlay, not operating expenditure by itself.

Unless circumstances change, we do not propose to repeat previous detailed and time-consuming benchmarking exercises, as their strength is in identifying large performance gaps, which all current evidence points firmly against.

We consider that restructuring initiatives should be self-financing from outperformance savings, not financed directly by customers.

Increases in non-payment of bills by customers should be managed, as Scottish Water has done in the past. This will be helped by having the lowest average bills in Great Britain and stable charges.

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