

Scottish Water's draft business plan: Base expenditure

Scottish Water published its draft business plan on 30 October 2013. This note is one of a series that the Commission is publishing to provide an objective assessment of the plan and to facilitate discussions between the Customer Forum, Scottish Water and other relevant stakeholders.

The Commission is aware that Scottish Water and the Customer Forum have been in regular and detailed discussion over many months. In drafting these notes the Commission has been briefed by the Customer Forum on its emerging thinking having seen the draft business plan as it was being developed. As such the notes contain advice on areas that the Customer Forum has identified as being important to it.

The notes highlight the strengths of the business plan and areas where the Customer Forum may wish to focus its discussions with the company. Although each note focuses on specific areas of the plan that are material to customers, final decisions should be taken 'in the round', reflecting the overall package of price and service levels agreed between the Customer Forum and Scottish Water.

Introduction

This note outlines the Commission's view on Scottish Water's operating and capital maintenance costs (together known as 'base expenditure'). In our view, the Customer Forum should consider these two areas of cost together because a company has quite significant discretion in how it allocates its expenditure between them. Base expenditure accounts for more than half of Scottish Water's annual expenditure, so is a key element of the price setting process.

Overview of Scottish Water's proposals

Scottish Water's proposals are set out in the following table:

£m, 2012-13 prices	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Capital maintenance expenditure	275	277	279	281	283	285
Total operating expenditure	506	508	506	504	503	503
<i>PPP charges</i>	152	152	152	152	152	152
<i>Controllable operating expenditure</i>	237	237	236	234	232	230
<i>Non-controllable operating expenditure</i>	107	107	107	107	107	107
<i>Cost of new obligations</i>	10	11	12	12	12	14

Capital maintenance

In our response to Scottish Water’s Service Improvement Report on capital maintenance we said that there was scope for greater clarity on expenditure and the resulting service levels.

Turning to Scottish Water’s draft business plan, we note that some expenditure (which Scottish Water classes as enhancement investment) could potentially be considered as capital maintenance expenditure. Scottish Water has since confirmed to us that this is expenditure to improve levels of service to the desired future level. Although we accept this explanation we consider that the Customer Forum should now seek to agree more detailed commitments from Scottish Water on the defined and observable improvement in levels of service¹ that will result from this additional expenditure.

Scottish Water is requesting an increase of around 12% on its average annual maintenance expenditure for the current regulatory control period (2010-15). The company’s maintenance expenditure will have been higher than was allowed for in the last Strategic Review of Charges and has been on an upward trajectory. At that time we set an allowance for capital maintenance of £224 million in 2007-08 prices. These upward pressures on maintenance expenditure are also observable in England and Wales.

We consider that the proposed increase is reasonable, given that Scottish Water intends to provide higher levels of service and, in common with the companies in England and Wales, is making increased use of assets with shorter lives to comply with European public health and environmental standards. At our request, the Independent Assuror has also reviewed Scottish Water’s capital maintenance proposals in detail². The Assuror concluded that the increases do not appear unreasonable.

Predicted five-year average capital maintenance for 2010-15 (2012-13 prices)	£249m
Proposed average annual investment 2015-21 (2012-13 prices)	£280m
Increase	12%

Operating expenditure

Scottish Water’s operating expenditure in 2012-13 was £499 million. Its operating expenditure can be divided into controllable costs and those costs over which the company has little control. Non-controllable costs include taxes, rates, PPP contract costs, licence fees and other similar items. Our analysis concludes that £243 million of the operating expenditure in 2012-13 should be regarded as controllable. Further information is attached at Appendix 1.

Assessing Scottish Water’s relative service and base expenditure performance

In previous price reviews we used a suite of econometric models and a separate unit cost model to assess the operating expenditure and capital maintenance efficiency gaps that existed between Scottish Water and the leading companies south of the border. In 2009 we decided not to use the

¹ Improvements may manifest themselves in increases in absolute standards or reductions in the risk of achieving the accepted standard.

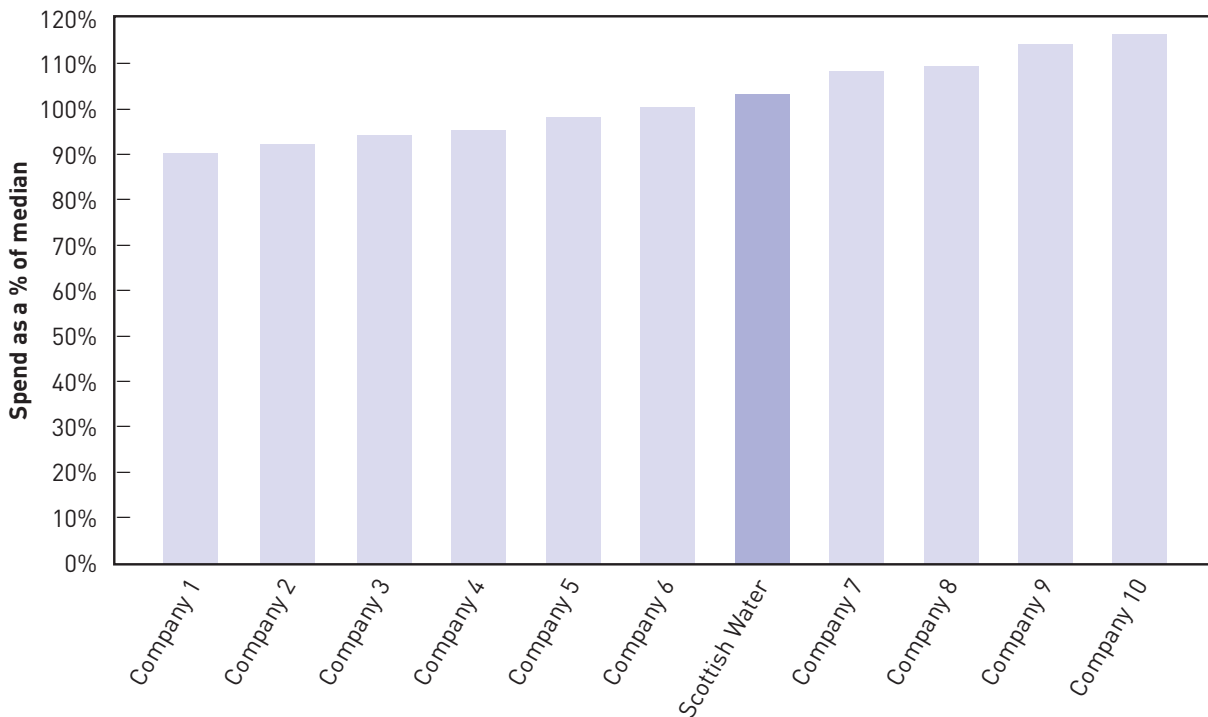
² The Independent Assuror’s report ‘Scottish Water’s approach to capital maintenance – Report by the Independent Assuror’ is available on our website.

results of these models but instead to require Scottish Water to hold its level of operating expenditure broadly flat after inflation. This required Scottish Water to improve services and meet the costs of operating new assets from its existing budget for operating expenditure.

In our view this was a more demanding challenge. It also required Scottish Water to save money from other budget areas if it needed to spend more on maintaining its assets. It appears that it was able to do so.

We believe that a similar challenge is appropriate for this price review. We have compared levels of unit costs and these show that Scottish Water has improved considerably. Although its unit costs are between 5% and 10% higher than the median for the companies in England and Wales, this is reasonable for a company that will be expected to deliver a high level of service given the asset base and rurality of much of its supply area.

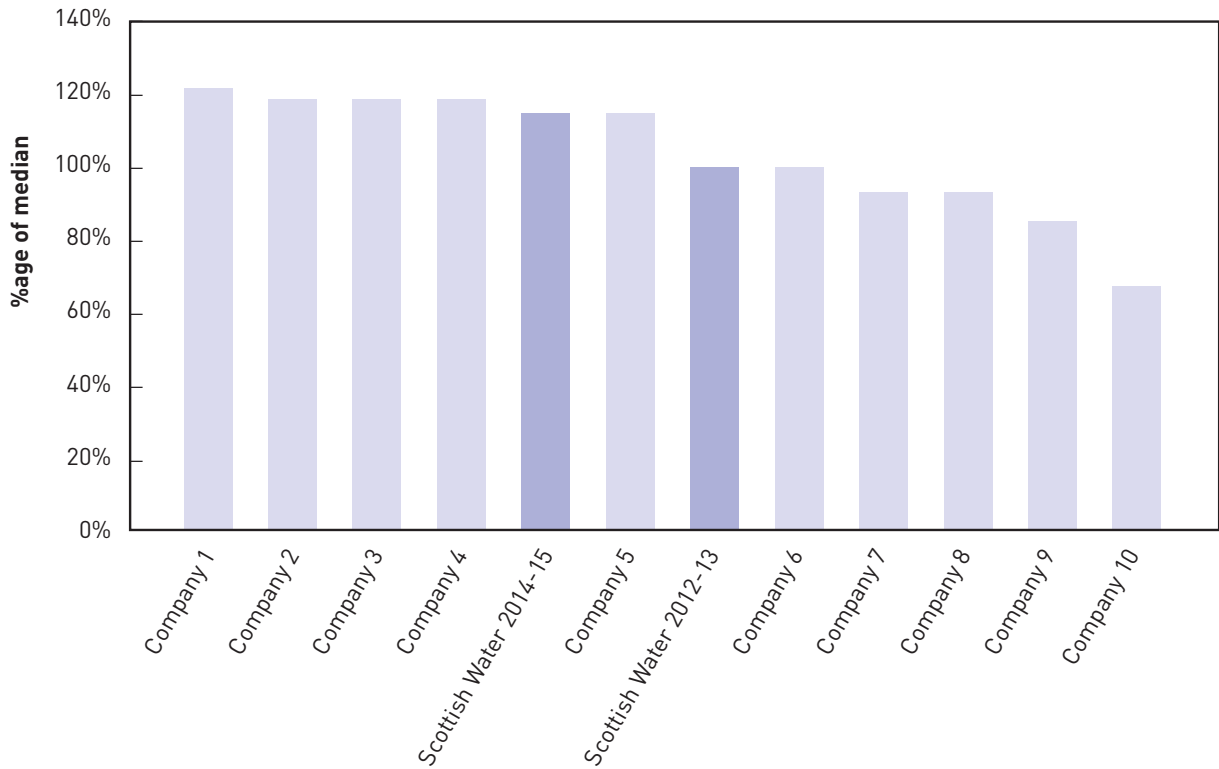
Comparison of total expenditure to operate and maintain assets with England and Wales water and sewerage companies



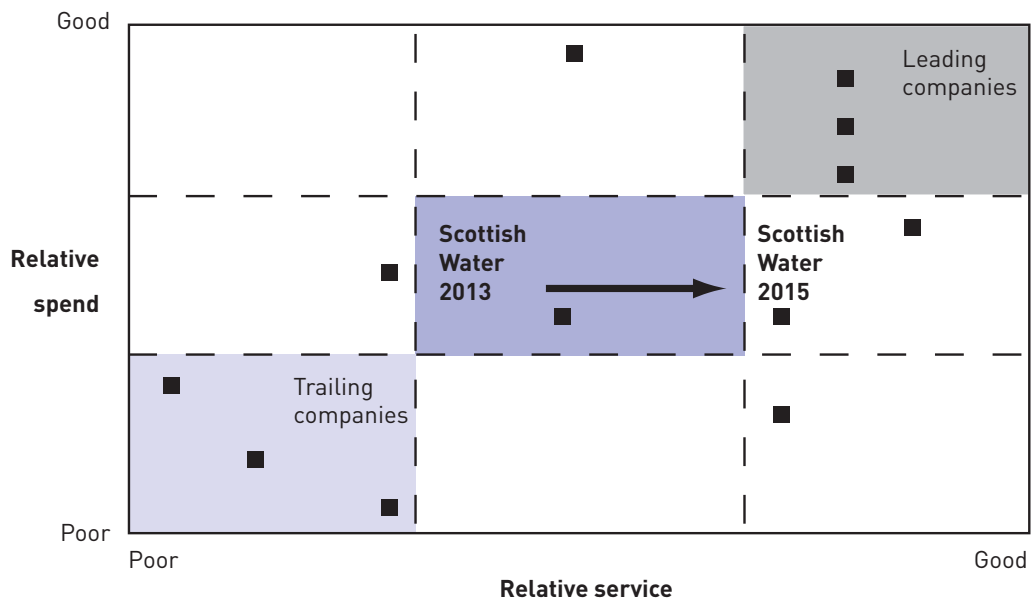
We have also carefully reviewed Scottish Water’s levels of service. In our view, Scottish Water has some scope for further improvement given the proposed levels of cost to be incurred³. However, given that the scope for cost savings by Scottish Water over the period may only result in relatively modest downward adjustments, the Customer Forum may be better advised to focus on seeking defined and observable improvements in levels of service. In Customer Forum note 19 we set out some thoughts on levels of service.

³ Its position on each indicator in 2012-13 is set out in Appendix 3.

Aggregated key performance indicators 2012-13 and Scottish Water's expected performance in 2014-15



Our analysis is summarised in the following figure. This sets out relative levels of service and relative unadjusted unit costs. It suggests that Scottish Water's performance is currently broadly in line with the average but that it is on an improving trend (indicated by the arrow in the performance matrix).



Conclusion

On balance, we consider that Scottish Water's proposals for its base expenditure in its draft business plan are broadly reasonable. They appear to be generally consistent with the ranges that we have previously set out for the Customer Forum.

However, Scottish Water has an opportunity to become unquestionably a leading company by the end of the next regulatory control period. There is still scope for cost reduction, however, if Scottish Water is to be among the very best performing companies at the end of this coming regulatory control period, it is likely that it will need to reduce its controllable operating expenditure by approaching 10% relative to that of its peers. Given both the uncertain nature of any cost saving projections and that Scottish Water's performance is already broadly in line with the average and on an improving trend, customers are likely to benefit most if Scottish Water focuses on improving its customer service and the resilience of its assets. We consider that the Customer Forum should therefore focus on seeking substantial and observable improvements in Scottish Water's levels of service and ensuring that these are as well defined as possible.

There is also scope for the Customer Forum to seek further improvements in the resilience of supplies to customers and to address some other potential priorities (such as improving supplies to rural areas) that are not explicitly covered in the plan. It should be possible to address these areas within an allowed for revenue consistent with lower prices, revised growth assumptions and a lower closing cash balance. In any trade-off with cost reduction, we believe the Customer Forum would be best advised to focus on customer service and the targeted level of resilience.

The financial tramlines will protect both customers and Scottish Water if these suggested trade-offs are not broadly balanced.

Appendix 1: Scottish Water's 2012-13 operating expenditure

Scottish Water's operating expenditure 2012-13	£m
Total operating expenditure	499
PPP charges	
Operating costs	109
Financing charges	24
Loan repayments	16
Non-controllable operating expenditure	
Service charges SEPA	11
Local authority rates	61
Bad debt charge	28
Third party services	7
Controllable operating expenditure	243

Appendix 2: Scottish Water's relative service performance

Measure	Performance 2012-13
Restrictions on water use	Upper quartile
Leakage relative to target	Upper middle quartile
Drinking water quality	Lower quartile
Interruptions to supply	Lower quartile
Internal flooding incidents	Upper middle quartile
Serious pollution incidents	Upper middle quartile
Sewage treatment works compliance	Lower middle quartile
Household retail performance	Upper middle quartile
Greenhouse gas emissions	Upper middle quartile
Satisfactory sludge disposal	Upper quartile

Appendix 3: Scottish Water's operating expenditure proposals

£m, 12-13 prices	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Total operating expenditure	353	353	355	354	352	350	350
Less uncontrollable operating expenditure:							
Service charges SEPA	11	11	11	11	11	11	11
Local authority rates	61	61	61	61	61	61	61
Bad debt charge	28	28	28	28	28	28	28
Third party services	7	7	7	7	7	7	7
New operating expenditure from service improvement and growth	6	10	11	12	12	12	14
Total controllable operating expenditure	241	237	237	236	234	232	230
Annual change in controllable operating expenditure	0.7%	-1.6%	0.2%	-0.7%	-0.8%	-0.8%	-0.8%

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