

## **Strategic review of charges 2010-14: stakeholder workshops 2009**

### **Discussion paper 7: Operating costs**

Welcome to our seventh stakeholder workshop of 2009 on the strategic review of Scottish Water's charges for 2010-14.

Later this year we will determine limits on:

- the amount Scottish Water can charge household customers;
- the 'default tariffs' that suppliers in the newly competitive market must offer business customers; and
- the maximum wholesale price Scottish Water can charge retail suppliers.

This workshop is the seventh of eight designed to discuss the high level areas that will inform the price setting process. It focuses on our proposed approach to establishing the appropriate level of operating costs to allow for during the 2010-14 period. This paper provides some context to the issues we will be discussing at the workshop. We welcome your views and any questions you may have.

### **Background to operating costs**

#### **What are operating costs?**

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 the Scottish Environment Protection Agency 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 2007-08, 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.

## **Scottish Water's performance on operating costs to date**

After Scottish Water was formed in 2002 from the three former water authorities it made excellent progress in reducing its operating costs. There was an overall reduction in running costs of almost 40%, with total cumulative savings of more than £800 million (as at 31 March 2008).

Although the pace of the reduction in these costs has flattened out in recent years, Scottish Water continues to exert good control of its costs across the business. This is evidence that the clear incentive framework that we put in place at the last Strategic Review of Charges (published in November 2005) is serving customers well.

Furthermore, at the same time as reducing its operating costs, Scottish Water has achieved demonstrable improvements in customer service. To measure performance we use a points-based system, the overall performance assessment (OPA), which encompasses the aspects of service that are most important to customers. This includes aspects such as the speed with which customer enquiries are dealt with and the risk of sewer flooding.

At the review we set a target for Scottish Water to achieve an OPA of 250 by 2010 – an improvement of 40%. This target was subsequently amended to 241 to take account of the fact that Scottish Water is no longer responsible for retail non-household services following the introduction of competition in April 2008. We were pleased to announce in October 2008 that Scottish Water had reached a score of 248 for 2007-08. This put Scottish Water only two points away from its target for 2009-10.

## **Considerations for the draft determination**

In reaching our initial conclusions about the appropriate level of operating costs to allow for and the efficiencies to assume, we will need to consider the following:

**Levels of service** – In order to assess Scottish Water's true level of efficiency, we need to not only consider the costs it incurs but also the outputs, in this case the levels of service it delivers. For instance, if Scottish Water incurred the same level of operating costs as the English and Welsh companies, but delivered a lower level of service, it would not be deemed to be as efficient as those companies. Scottish Water's level of service is currently within the range of that received by customers in England and Wales.

Although we have been pleased by the improvements reported to date, there is no room for complacency. We therefore proposed that Scottish Water should match, by 2013-14, the performance of the leading companies in England and Wales in 2007-

08. This proposal was widely accepted by stakeholders and by Scottish Water in its second draft business plan (submitted to us in March 2009). We expect that any costs of further improvements will be absorbed through efficiencies elsewhere in the business. This is the experience in England and Wales, where total operating costs have remained broadly flat in real terms over the last 20 years.

**Extent of the efficiency challenge** – We anticipate that Scottish Water will not yet be as efficient as the companies in England and Wales. It is important that we continue to challenge Scottish Water to continue to narrow the efficiency gap – but by how much? Again, we proposed that Scottish Water should match, by 2013-14, the performance of the leading companies in 2007-08. This proposal was also widely accepted by stakeholders and by Scottish Water in its second draft business plan. It allows us to tie Scottish Water’s efficiency challenge to a level of performance that has been demonstrably achieved before.

**Assessing the size of the efficiency gap** – In order to assess how well Scottish Water is performing compared with the English and Welsh companies, we propose to take broadly the same approach as at the last review. We propose to use three different modelling approaches to assessing efficiency. We will also continue to make adjustments for special factors, and differences in the scope of activities with England and Wales. The latter now includes the impact of retail competition for non-household customers.

**Scottish Water’s business plan proposals** – in its second draft business plan Scottish Water asserted that its operating costs would need to increase by between 10% and 15% by 2010 (after efficiency savings and after absorbing the costs of levels of service improvements) if it is to continue to deliver services. It cited, among other things, increases in non-domestic rates, pensions contributions, bad debt and SEPA charges. We are probing this area of Scottish Water’s business plan closely, in order to ensure that best value for customers is achieved.