

Stakeholder workshop 7: Scottish Water's operating costs

Strategic Review of Charges 2010-14: 2009 workshops
Stirling, 21 May 2009

Programme for the morning...

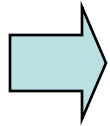
Overview of the price review process

Overview of our approach to operating costs

Scottish Water's business plan proposals

Your views and questions

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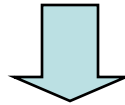
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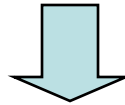
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The price review process focuses on delivering value for money for customers. The process can be summarised in three high level steps....

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.

At the end of the process, we are able to determine the following:

1. Limits on the amount Scottish Water can charge household customers annually between 2010-14.
2. The 'default tariffs' that licensed suppliers in the newly competitive market are required to offer all business and public sector customers in Scotland.
3. Limits on the wholesale price Scottish Water can charge retail suppliers of business and public sector customers.

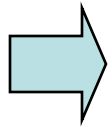
The final outcome is a regulatory contract setting out what Scottish Water must achieve and the financial parameters in which it must do so.

We're now reaching the final stages of the price review...

When?	What?	Why?
Expected by end of February 2009	Ministers issue principles of charging statement	Sets out principles that should underpin charge caps. For instance, household charges should be linked to council tax.
13 March 2009	Scottish Water publishes its second draft business plan	Scottish Water sets out the funding it will need to achieve Ministers' objectives. Used by us to calculate price limits.
30 June 2009	Draft determination published	We publish our draft view on price limits – a 12 week consultation period follows.
23 September 2009	Ministers issue directions	Ministers issue formal directions to Scottish Water, revising where appropriate in the light of the draft determination.
30 November 2009	Final determination published	We publish our final view of price limits.
31 January 2010	Competition Commission appeal deadline	Scottish Water has a two month period to accept or reject our determination.

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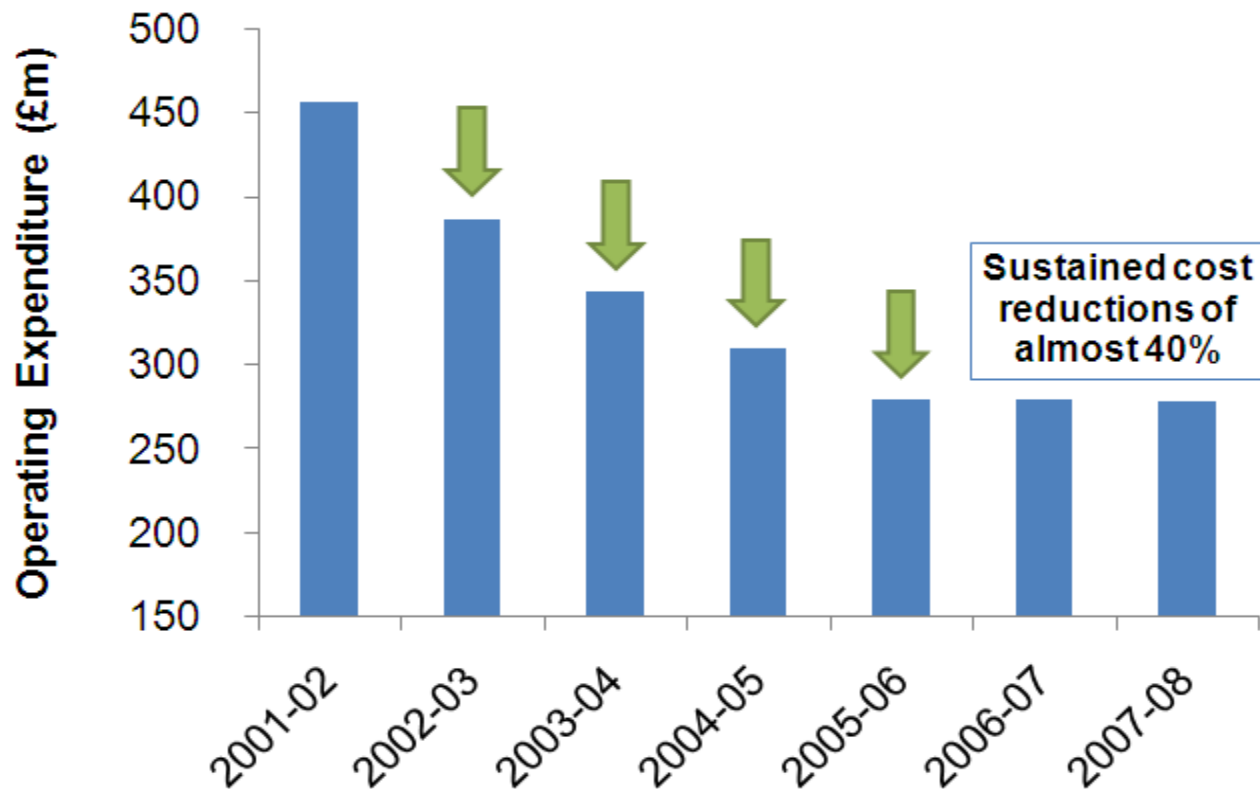


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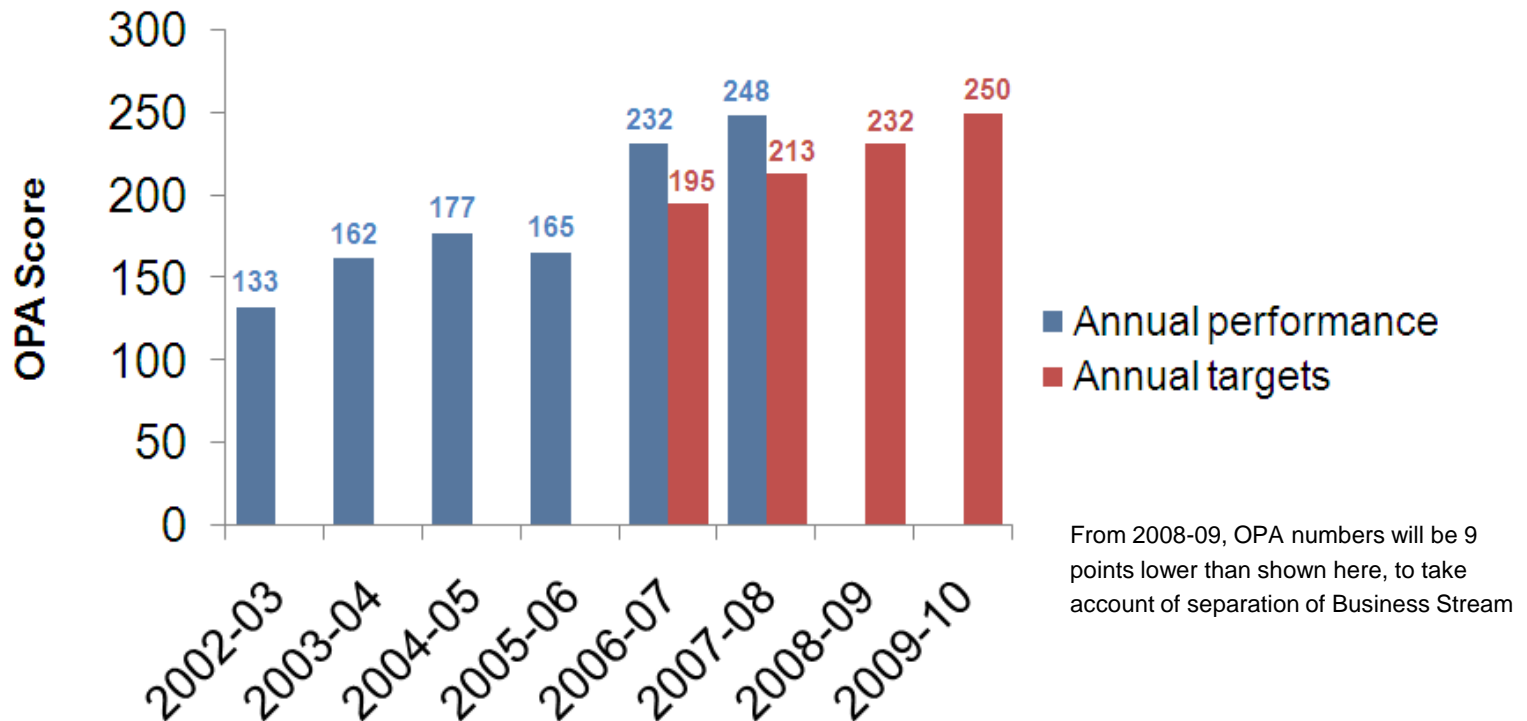
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Scottish Water made unprecedented reductions in operating costs after the 2001 price review...



Costs are now stable, but are they at an efficient level?

Before we can answer that, we need to see what service customers are getting for the money...



Service is improving, but could still improve further (the best company scored 329 in 2007-08)

We use econometric models to benchmark Scottish Water's operating costs with the rest of the water industry...

- Econometric models were developed by Ofwat in late 1990s, with some revisions since
- Were endorsed by the Competition Commission in 2000 and 2007
- Used by Ofwat in 1999, 2004 and 2009 price reviews to assess scope for companies to reduce costs towards the 'frontier' company
- Used by WICS in 2001, 2005 price reviews for the same purpose

We use econometric models to benchmark Scottish Water's operating costs with the rest of the water industry...

- We extend Ofwat's econometric models to Scotland and recalibrate them
- We use an alternative model, developed by the office, as a cross-check
- We make sure our comparisons are like for like with England and Wales:
 1. We correct for the impact of retail separation
 2. Ensure PPP information is removed
- We ensure that modelled costs are consistent with Scottish Water's operating cost baseline

We take care to allow for Scottish Factors

- Our models already take account of much of Scotland's rural nature
- However, we recognise that the econometrics cannot include all factors that may impact costs
- We seek detailed evidence from Scottish Water on such 'special factors'
- We only allow for costs arising from particular operating characteristics beyond management control
- We require evidence that these upward cost pressures are being actively managed to limit the impact
- The process is not 'one-way'. We also account for factors that reduce Scottish Water's costs relative to the industry norm

In the past, we calculated an 'efficiency gap' to the 'frontier' company...

In 2001, we required Scottish Water to close 80% of the efficiency gap by 2005-06



	East	North	West	Scottish Water
Efficiency gap	47%	41%	47%	44%

In the past, we calculated an 'efficiency gap' to the 'frontier' company...

In 2005, we required Scottish Water to close half of the efficiency gap by 2009-10



	Water	Waste water
Efficiency gap	32%	24%

- but this also required us to forecast how the frontier company would improve, and to assess the degree of closure

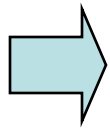
This time we will ask Scottish Water to match both the operating cost and OPA performance of the upper quartile English and Welsh companies in 2007-08 by 2014.

- By considering operating costs and levels of service together, we will get a more accurate measure of Scottish Water's comparative operating efficiency.
- We know the expected level of performance is realistically achievable.
- We avoid any uncertainty about how the companies to perform during 2010-15.
- We avoid any uncertainty about how Ofwat may change OPA measures during 2010-15.
- We are lessening the risk of asking customers to pay for improvements in service that they do not want.

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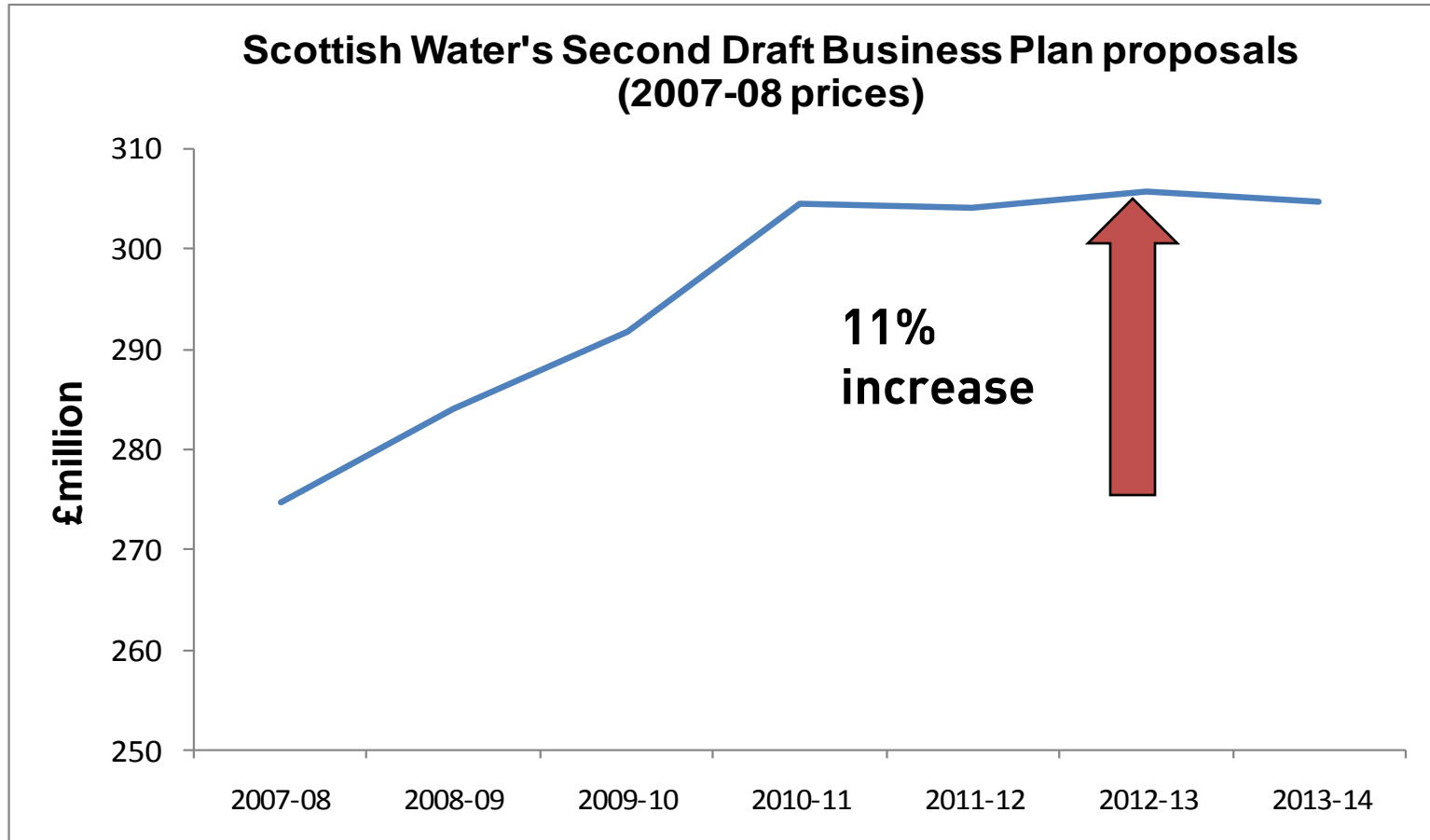
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In its draft business plans, Scottish Water accepted our proposed challenge...

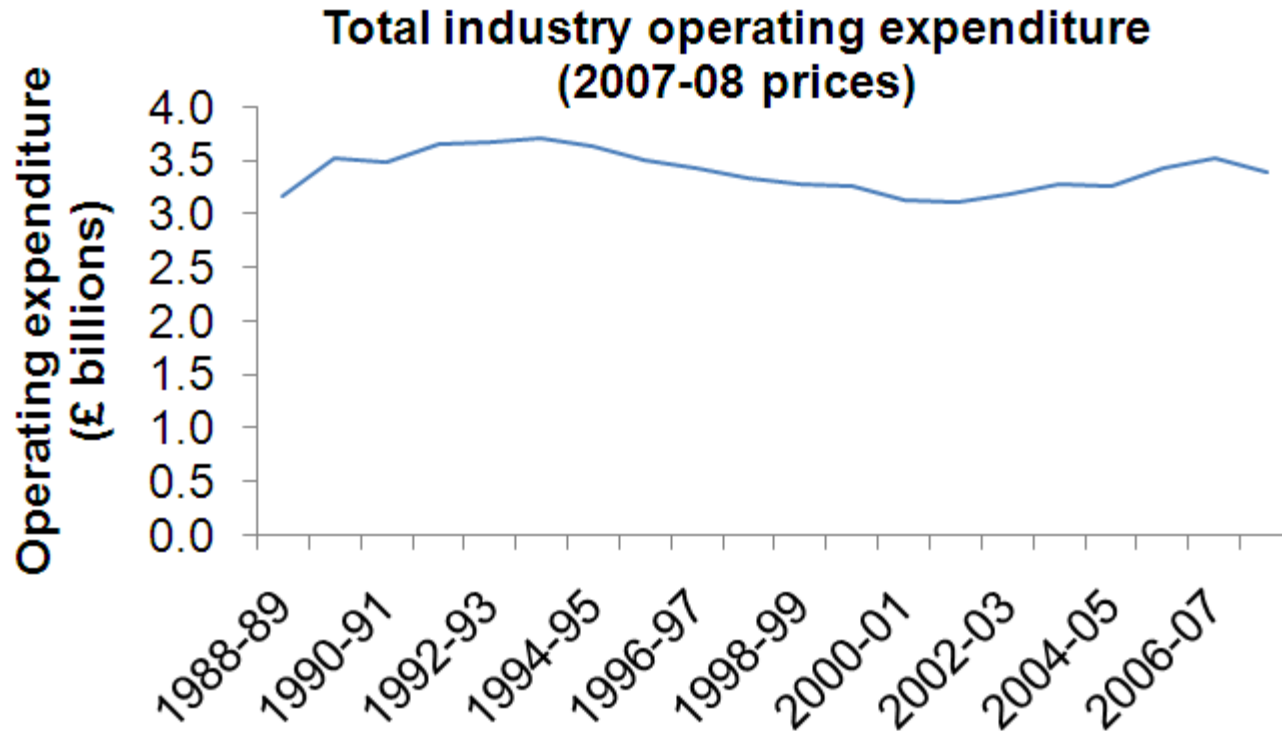
- It plans to improve its OPA score by around 33% by 2014
- It used a joint household customer survey with Waterwatch to support its planned priorities [low pressure; drinking water quality; climate change; interruptions to supply; bathing water quality; leakage; and internal and external sewer flooding]
- It requested an allowance for capital investment to help achieve this, specifically for improving security of supply, improving wastewater compliance and reducing pollution incidents
- It plans to achieve upper quartile operating cost efficiency
- It plans to absorb any cost increases incurred to improve OPA

Nevertheless, Scottish Water claimed a substantial increase in its core operating costs



We are looking at this closely, and may reach different conclusions...

Interesting parallels from England and Wales may inform our judgement...



Operating costs remain broadly flat in real terms over time –
efficiencies are mainly in improving quality, reducing leakage etc

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**For more information on the price review please go
to:**

**[www.watercommission.co.uk/view_future_prices.
aspx](http://www.watercommission.co.uk/view_future_prices.aspx)**