

Methodology Information Paper 16: Adjustment for Scottish factors

Introduction

In Methodology Information Papers 14 and 15 we explained that we benchmark Scottish Water's operating expenditure efficiency relative to the water and sewerage companies in England and Wales. This paper sets out how we adjust the results of our modelling to ensure that we have taken full account of any factors that are unique to Scotland.

We find it useful to think of two types of adjustment that we make for Scottish factors. These are:

- special factors, and
- the scope of activities.

We make adjustments to the extent that these Scottish factors are not already taken account of in our benchmarking.

Scottish factors already accounted for in the benchmarking

In order to benchmark Scottish Water, we use Ofwat's econometric models. Some commentators have questioned the application of Ofwat's econometric models to Scottish Water¹. These criticisms generally focus on perceived differences in Scottish Water's operating environment or on the different ownership structures.

The Ofwat models have been successfully applied to companies as different as Severn Trent Water and South West Water, and to both large and small water and sewerage companies as well as to the smaller water only companies. We believe that as Ofwat has successfully applied the models to such diverse companies we can reasonably apply these models to Scottish Water.

Moreover, we have revised the Ofwat models to include information from Scottish Water. This means that differences in Scottish Water's operating environment influence the models that we use before we make any discrete adjustments for Scottish factors.

The econometric models include variables such as the size of the required asset base and the area served. Scottish Water operates with a relatively large number of relatively small assets over a relatively large area. Our benchmarking takes account of such factors and allows for increased costs. Our modelling at the 2006-10 review allowed for an additional £30 million annually for Scottish factors.

¹ See, for example, J Findlay 'Financing the Scottish water and sewerage industry' paper to the Scottish Trade Union Conference, April 2004.

It should be noted that the majority of Scottish Water's operating environment is directly comparable with that in England and Wales. Most customers live within the central belt and most rural customers in Scotland are no more rural than customers in, say, Wales or the West Country. We do recognise, however, that there are exceptional circumstances and that our analysis should take account of these in assessing the level of costs to allow for.

Special factors

Ofwat's econometric models provide a simple explanation of water and sewerage company costs. Not every factor that might determine costs is included in the models. The factors that are included are the principal cost drivers. They are the most relevant to explaining the costs of the companies south of the border and Scottish Water.

For an individual company, it is possible that there are additional factors that are not included in the models but which influence costs. These are known as 'special factors' because they may be relevant to just one or two companies' costs. Special factors can both increase or reduce costs. Perhaps not surprisingly, companies tend to concentrate on providing information about those factors that increase costs when explaining their efficiency to regulators.

Our allowances at the last price review

At the 2005 price review, Scottish Water claimed more than £50 million of special factors for operating expenditure. Following detailed analysis of the claim, we allowed for additional operating costs to reflect the following special factors²:

- the central regulatory laboratory,
- travel costs,
- electricity costs,
- bad debt,
- sewer laterals,
- water works sludge disposal,
- public septic tanks.

The total adjustment that we made in response to evidence on these factors was £17.5 million. We considered that Scottish Water's claims in respect of four other areas – leakage, service reservoirs and towers, political queries and cryptosporidium – did not merit an adjustment to the results of the econometric models.

² 'The Strategic Review of Charges 2006-10: The final determination', November 2005, Chapters 10-14 provides details. For further explanation, see 'The Strategic Review of Charges 2006-10: The draft determination', Volume 6, June 2005, Chapters 11-12.

Our proposed approach

As part of its business plan submissions, we will ask Scottish Water to submit its current views of the special factors that influence its costs. We again intend to take account of the special factors that are material and outside the control of management by adjusting the results of our models.

We intend to apply similar criteria to those used previously by the Commission and by Ofwat. For an adjustment to be valid, Scottish Water will have to provide a high standard of evidence. It will need to set out whether the factors are the result of particular legal, environmental or quality obligations upon it, the character of all or part of its customer base, or the result of historical development of the water and sewerage systems in its area of supply. Key questions to be addressed are:

- What are the special circumstances that produce a material difference from industry norms?
- What is the overall net impact of the special factors on Scottish Water's costs?
- What has Scottish Water done to manage the additional costs arising from the special factors and to limit their impact?
- Are there other special factors that reduce costs relative to industry norms? If so, have these been quantified and offset against the upward cost pressures?

We intend to seek confirmation of cost evidence from the independent Reporter.

We will give Scottish Water feedback on our initial assessment of the special factors that it includes in its first draft business plan. This will form part of our overall feedback on the first draft business plan on 31 July 2008.

In the Strategic Review of Charges 2006-10, we held a workshop with Scottish Water to discuss its special factor submission. We intend to hold a similar session as part of the 2010-14 review. This should increase transparency and should help ensure that our benchmarking of Scottish Water's operating expenditure is objective and fair.

The scope of activities

In order to make an accurate assessment of Scottish Water's efficiency relative to that of the companies south of the border, we need to take account not only of special factors, but also of the different scope of activities that Scottish Water undertakes. For example, unlike the companies south of the border, Scottish Water carries out no significant household metering.

The scope of activities within England and Wales is comparable. In general, Ofwat does not therefore have to adjust the result of its models to reflect any differences in the scope of activities. In Scotland, such differences in the scope of activities are material to customers as they influence the price they should pay. These differences can both add to and reduce the costs that Scottish Water incurs.

Our adjustments at the Strategic Review of Charges 2006-10

As part of the Strategic Review of Charges 2006-10, we asked Scottish Water to submit its views on adjustments to our benchmarking to take account of differences in the scope of activities. It did not include any scope adjustments within its business plan submissions; however, we were still able to take account of differences in the scope of activities in our benchmarking.

Table 1 summarises the differences in the scope of activities that we took into account at the Strategic Review of Charges 2006-10.

Table 1: Scope adjustments in the Strategic Review of Charges 2006-10

| Water service adjustments | Waste water service adjustments |
|----------------------------------|--|
| Household metering | Household metering |
| Non-household metering | Non-household metering |
| Leakage | Reporter costs |
| Nitrate removal | |
| Reporter costs | |

Our proposed approach

We will review any evidence from Scottish Water, the Reporter, Ofwat, the companies in England and Wales and other stakeholders before considering any adjustments to modelled operating expenditure to take account of differences in the scope of activities.

Conclusion

It is important that we take account of special factors and differences in the scope of activities. Adjusting for these Scottish factors helps us to ensure that we are making like-for-like comparisons and provides a more complete assessment of Scottish Water's relative operating cost efficiency.

Related documents

'The Strategic Review of Charges 2006-10: The draft determination', Volume 6, Water Industry Commissioner for Scotland, June 2005.

'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.