Methodology Information Paper 13: Establishing a baseline for operating costs

Introduction

In this information paper we review our approach to establishing a baseline for operating costs.

The paper begins by outlining how we propose to define the base year and the corresponding baseline for the regulatory period 2010-14. The paper explains the possible adjustments to the baseline. It continues with a description of potential new operating costs and how we expect to deal with these.

Operating costs

What is included

Operating expenditure comprises day-to-day running costs. It does not include capital investment or financing costs. Operating expenditure therefore includes employment costs, electricity, materials, hired and contracted costs, local authority rates, insurance, software licences and vehicle running costs. Bad debt is also regarded as a running cost.

Information about operating costs

We collect information about the operating costs incurred by the water and sewerage service undertakers in the UK. The consistency of our regulatory return with that which is used by Ofwat allows us to make robust comparisons with other water and sewerage companies. The June Return from Scottish Water allows us to analyse operating costs by both function and activity. The June Return defines these functions and activities in the same way as Ofwat's equivalent return. As a result, we do not have to make many adjustments to the reported information in order to benchmark performance.

The analysis of expenditure by function provides information about what it costs to provide a particular service. The analysis by activity shows the cost of each activity comprising a service.

The breakdown by function is shown below:

- Water service:
  - water resources and treatment
  - water distribution
  - business activities.

- Sewerage service:
  - sewer network
  - sewage treatment
  - sludge treatment and disposal
  - business activities.

The breakdown by activity is as follows:

- Direct costs:
  - employment
  - power
  - hired/contracted services
  - agencies
  - materials and consumables
  - charges levied by environmental regulator
  - bulk water imports
  - other.

- General and support

- Business expenditure:

  - customer services
  - scientific services
  - local authority rates
  - doubtful debts
  - exceptional items
  - third party services
  - other.

Both Scottish Water's one-off costs and those of the companies south of the border could affect comparisons. Our assessment of Scottish Water's relative efficiency in operating expenditure (that is, Scottish Water's efficiency when compared to that of the companies in England and Wales) takes into account reported one-off costs. As such, our analysis of Scottish Water's operating expenditure (as reported in its June Return) endeavours to be as accurate and as fair as possible.

We require Scottish Water to report two operating expenditure figures; one for base service, and one for total operating expenditure. The companies in England and Wales also report two operating expenditure figures. Base service expenditure comprises the cost that is incurred simply to maintain a constant level of service from some agreed starting point. Total operating expenditure includes both the operating costs relating to maintaining the base service and any net additional running costs associated with improvements. It is possible to compare the underlying trends in operating expenditure more fairly if new net additional costs are reported separately. The treatment of such new operating costs is covered later in this paper.

The 'base year' and 'baseline' costs

Performance in the base year is the starting point against which future performance is measured. We propose to use 2007-08 as the base year for this price review. 2007-08 is the last full year before the price review for which we will have information from both Scottish Water and the companies in England and Wales. It is also likely to be the last year for which we will have complete information about retail supply operating costs.

To establish the level of baseline operating costs for 2007-08 we propose to:

- take reported core costs,
- adjust for atypical costs (or savings),
- remove exceptional costs, and
- ensure that cost allocation practices are consistent with those in England and Wales.

We have previously explained this process in more detail.

Adjustments to the baseline

Scottish Water may produce evidence in its business plans of changes, up or down, in future baseline costs.

Our baseline for operating costs will take account of potential changes in costs during the regulatory control period. We propose to take account of any potential changes that are outside the control of management and not fully reflected in consumer price inflation. Examples of such changes could include increases or reductions in, for example:

- local authority rates,
- landfill tax,
- pension costs, and
- energy prices.

It will be important to analyse any evidence carefully in order to ensure that Scottish Water has sufficient resources to deliver ministerial objectives. We propose to use the following criteria to assess potential changes in underlying costs:

- If the future changes are the result of an economy wide factor, will their impact be accounted for in national inflation indices?
- What measures have Scottish Water's management taken to reduce the impact of future increases in baseline operating expenditure?
- Where appropriate, has Scottish Water taken account of external advice in respect of the forecast changes? For example, when we

look at pension costs, we would expect any forecast changes to be supported by an actuarial valuation.
- Are there any offsetting factors that we believe Scottish Water has failed to take into account?
- What views have been expressed by other utility regulators (such as Ofwat and Ofgem), when assessing similar claims by the companies they regulate?

New operating costs

The baseline applies to costs that are already being incurred to deliver a particular set of outputs and level of service. However, it is likely that over the 2010-14 regulatory control period, Scottish Water will incur new operating expenditure to deliver improvements in:

- environmental standards,
- drinking water standards,
- levels of service to customers, and
- more effective management of the supply/demand balance for water resources.

It is important that we scrutinise carefully Scottish Water's claims for new operating costs before they are included in price limits.

Defining new operating expenditure

New operating expenditure arises from the following:

- Improved environmental standards.

  Examples of environmental obligations include the Urban Waste Water Treatment Directive and the Bathing Water Directive. In common with other water and waste water providers in Europe, Scottish Water has to comply with both European and national legislation. In many cases, compliance will be achieved through capital expenditure on new or upgraded waste water treatment plants. These upgraded plants may have higher operating costs. For example, secondary activated sludge treatment ensures higher levels of compliance, but uses more power than primary treatment and therefore may lead to higher operating costs.

- Improved drinking water standards.

  Examples of drinking water obligations include the cryptosporidium regulations and legislation to reduce the amount of lead in drinking water. Meeting these obligations often requires capital expenditure on water treatment works or the water distribution system. Meeting these obligations may also lead to increases in operating

expenditure, for example through increased monitoring of water quality or increased rates of chemical dosing.

- Higher levels of service to customers.

  There is still a significant gap in customer service between Scottish Water and the companies south of the border. The companies in England and Wales have significantly increased operating expenditure to improve customer service in the past 15 years. When we benchmark Scottish Water's operating cost performance, the costs to companies of maintaining higher levels of service are already taken into account. We therefore propose to make no further allowances for the improvements required of Scottish Water in this area .

- More effective management of the supply/demand balance.

  Maintaining an appropriate supply/demand balance ensures that there is sufficient capacity (of both water and waste water) for Scottish Water to meet the demands of new customers and/or the increasing demands of existing customers. In the long term, Scottish Water may meet increased demand for water and waste water services by building new water treatment and sewage treatment works. In the short term, however, increased demand can often be dealt with through operational measures. For example, increased demand for water could be met by incremental reductions in leakage or by employing demand management techniques such as metering. Either approach may increase operating costs.

Each of these factors would lead to increases in operating expenditure. We are specifically interested in the net new operating expenditure.

How to calculate new operating expenditure: an example

New legislation requires a water and waste water undertaker to achieve higher standards of effluent discharge. A waste water treatment works is already in place, but the treatment processes employed will not meet the new required standards so the plant needs to be replaced. Currently, the works incurs £50,000 a year in operating expenditure. The new compliant treatment processes will incur £75,000 a year in operating expenditure. The new operating expenditure is the difference between the post-investment level of operating expenditure and the pre-investment level (ie £75,000 less £50,000). Net new operating expenditure is therefore £25,000 per year.

Importance of new operating expenditure

Since privatisation in 1989, the companies in England and Wales have incurred significant new operating expenditure. This is in large part due to higher standards of public health and environmental protection that have required increasingly sophisticated treatment processes. Growth in the demand for services and improvements in levels of service are also significant drivers of new operating expenditure. Annual new operating expenditure represents approximately 1% of total operating expenditure in the water and sewerage companies in England and Wales.

New operating expenditure will, over time, represent a significant part of total operating expenditure.

How we propose to deal with new operating expenditure

New operating expenditure can place an upward pressure on customers' bills. It is therefore important that Scottish Water provides a clear justification for any new operating costs that it expects to incur, and that any claims for new operating expenditure undergo careful scrutiny. Customers should not be expected to pay for unnecessary or inefficient levels of new operating expenditure. We propose to require Scottish Water to detail claims for new operating expenditure in its business plans. In assessing the merit of any claim, we propose to pay particular regard to the level of performance delivered by the leading companies in England and Wales in 2007-08.

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.