

Stakeholder workshop 3: Scottish Water's operating costs

Why are Scottish Water's operating costs important to customers?

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 SEPA 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 2005-06, 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.

Progress so far

As part of our assessment of the lowest overall reasonable cost, we need to determine an appropriate level of operating costs. We did so at the last review (using information provided by Scottish Water) by assessing the following:

Baseline expenditure - The baseline level of operating expenditure is the underlying expenditure incurred in the base year. We assessed this by adjusting reported expenditure in the regulatory accounts to correct for unusual or 'one-off' items.

Future changes to baseline expenditure - We projected the baseline forward for the current regulatory period, adjusting underlying expenditure to take account of expected changes. These arose, for example, from increases in pension contributions, local authority business rates, SEPA charges and the cost of electricity. We only allowed for such changes where evidence provided by Scottish Water could be confirmed independently.

New operating expenditure – We recognised that during the regulatory control period, Scottish Water would incur new operating costs in order to deliver improvements in its service, for instance, in environmental compliance. We allowed only for those costs that were consistent with the make up and forecast timing of the investment programme.

An appropriate level of efficiency – In order to ensure that our allowance for operating costs was no higher than it needed to be, we compare Scottish Water's operating costs with those incurred by the English and Welsh water and waste water companies, and in order to make an efficiency assessment, we considered the outputs that were delivered in return for those costs. We use four different econometric models to assess Scottish Water's efficiency (using baseline costs) compared with what has been achieved elsewhere.

It was important to carry out this assessment on a 'level playing field'. We made a number of adjustments to the efficiency assessments generated by our models. These adjustments took

account of special factors and differences in the scope of activities provided by Scottish Water and by the benchmark companies. Several special factors were allowed for, including for example the costs of providing services in remote areas and higher unit electricity costs in Scotland. The adjustments for scope of activities took account, for example, of much lower costs of reading meters in Scotland, given the low proportion of metered customers.

Scottish Water's efficiency was lower than would be achieved by the leading company in England and Wales, we therefore adjusted its allowed for profile of operating costs to enable it to begin to close this gap. At the 2006-10 review we required Scottish Water to narrow 50% of the assessed gap.

However, our assessments did not take account of Scottish Water's generally lower levels of service to customers. Rather than correcting our analysis for this difference, we set specific targets to improve levels of service within the profile of costs allowed for.

Issues for the next review

There are three principal areas where we propose to take a different approach at the next price review. These are:

- adjusting our approach to take account of the introduction of competition;
- ensuring our approach takes account of the true efficiency gap between Scottish Water and the companies south of the border (ie the level of costs incurred and level of service provided to customers); and
- how we define the scope for improvement and the targeted level of performance.

The first of these is required by the introduction of the licensing framework established by the Water Services etc (Scotland) Act 2005. The second two areas reflect our experience of setting targets at the Strategic Review of Charges 2006-10.

Issues in detail

Introduction of competition – Since the last review, Scottish Water has created a separate entity to provide retail services to non-household customers. In order to ensure we continue to make like for like comparisons with England and Wales, we need to adjust the way we assess Scottish Water's operating expenditure efficiency to reflect this change. There are two key ways we could approach this challenge, we would welcome stakeholders' views on them.

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. We recognise that Scottish Water's level of service is currently lower than that provided in England and Wales. We could take account of this by setting Scottish Water targets to improve its performance to a broadly comparable level to England and Wales. We used this approach at the last review. However, we could ask Scottish Water to provide us with information on the additional operating expenditure it would require to bring its levels of service into line with England and Wales. We would take this into account in our efficiency assessment.

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? We could require Scottish Water to match the performance of the leading company in England and Wales in 2007-08 by the end of the 2010-14 regulatory control period – this is a level of performance that has been demonstrably achieved before. A second possible approach would be for us to continue to set

future performance targets based on an estimate of where the leading companies will be by the end of the regulatory control period.

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 continue to use four 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.