

Workshop

Stakeholder workshop 3: Scottish Water's operating costs

Strategic Review of Charges 2010-14: Methodology
Stirling, 31 May 2007



Key dates for the price review

Methodology consultation published	10 May –26 July 2007
Methodology consultation period closes	19 October 2007

SW submits first draft business plan 30 May 2008

Ministers issue guidance 30 September 2008

SW submits second draft business plan 13 March 2009

Draft determination of price limits published	30 June 2009
Draft determination consultation closes	23 September 2009

Ministers issue directions 23 September 2009

Final determination of price limits published	30 November 2009
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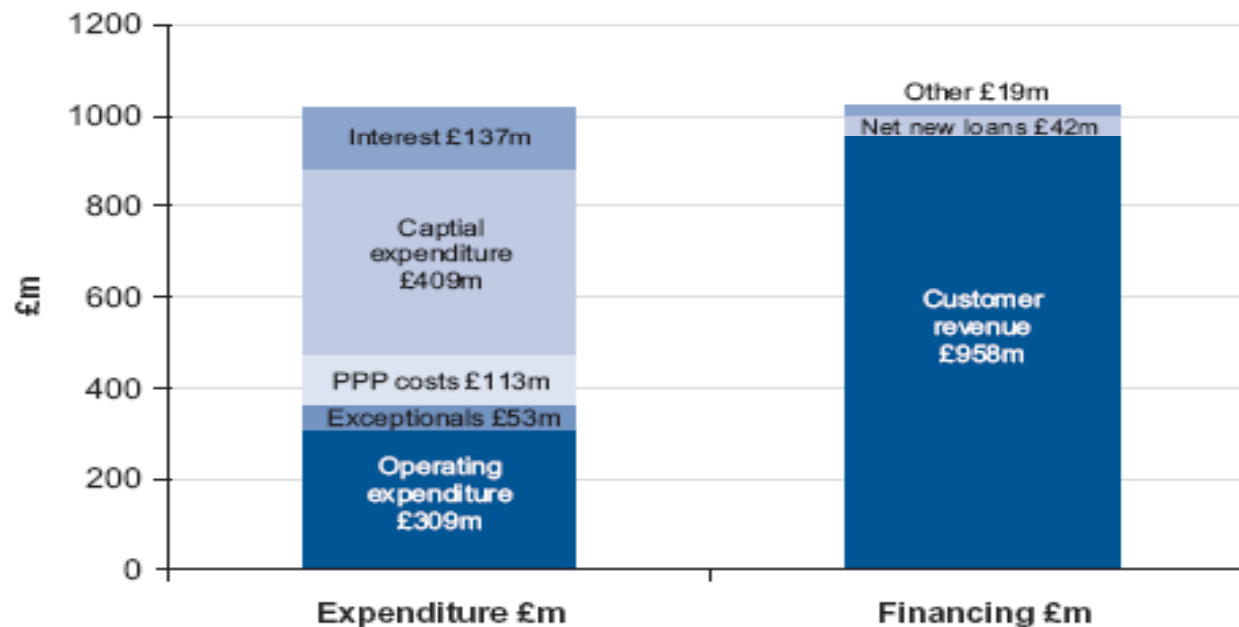
Methodology consultation

- The methodology consultation will be published in 4 volumes during May, June and July.
- For each volume we will hold two workshops for stakeholders.

Volume	Publication date	Workshops
1. Financing Scottish Water	10 May 2007	12 April 2007 26 July 2007
2. Customer revenue and levels of service	Today	10 May 2007 16 August 2007
3. Operating costs	28 June 2007	31 May 2007 30 August 2007
4. Capital expenditure	26 July 2007	28 June 2007 20 September 2007

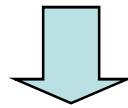
Operating costs are an important component of Scottish Water's overall expenditure...

In 2003-04, operating expenditure represented c.30% of overall expenditure. Operating expenditure covers for example employment costs, electricity, fuel, chemicals etc.

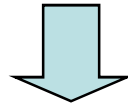


In a price review, we need to allow Scottish Water sufficient operating expenditure (opex), but no more than necessary. We approach this by....

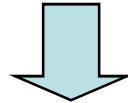
Assessing baseline opex (in a given “base year”).



Predicting and adjusting for future changes to the baseline. For instance, increases in pension contributions.



Allowing for new operating expenditure which is consistent with the investment programme.



Making an efficiency adjustment by comparing Scottish Water’s opex and the service it provides with the English and Welsh companies. We allow for specific differences in circumstances which affect this comparison.

Volume 3 of the methodology consultation will consider the following high level issues...

- How we should adjust our approach to take account of the introduction of competition
- How we can ensure our approach takes account of the true efficiency gap between Scottish Water and benchmark companies in England and Wales
- How should we define the scope for improvement and the targeted level of performance

The introduction of competition will affect how we make comparisons with England and Wales...

Scottish Water will no longer be responsible for retail services to non-household customers. We need to ensure that we continue to compare like with like.

Should we take account of this by:

deducting comparable “retail” costs from the English and Welsh companies;

or

adding back the operating costs incurred by Scottish Water Business Stream to Scottish Water’s total operating costs?

When we make efficiency assessments, we need to consider both the costs incurred, and the service provided...

Though improving, Scottish Water is not yet providing the same level of service as the English and Welsh companies.

Should we take account of this by:

setting targets for Scottish Water to improve its levels of service;

or

seeking to understand the costs that would be involved in improving service?

We anticipate Scottish Water will not yet be as efficient as the English and Welsh companies...

We use the English and Welsh companies as an indicator of what Scottish Water can achieve. In doing so, we should ask the following questions:

Is it reasonable to expect Scottish Water to be as efficient as the English and Welsh companies?

If so, which companies should we compare them with – the highest achievers, the top three, the industry mid-point?

Should we take into account expected improvements in the companies performance during 2010-14? Or should we ask Scottish Water to perform at a level that has already been achieved in England and Wales?

We assess efficiency by using econometric models...

We employ Ofwat's econometric modelling techniques to assess operating efficiency. We also test the results by using an alternative approach.

Is it reasonable to continue to use our existing econometric models? Are there other techniques and approaches we should explore?

Any other issues?