

Initial Decision Paper 10:
Operating expenditure

This is the tenth in a series of Initial Decision Papers that the Water Industry Commission will publish during the Strategic Review of Charges 2021-27. The Commission will issue initial, revised and final Decision Papers. These Initial Decision Papers set out, for customers and other stakeholders, the Commission's current views on important matters relating to the Strategic Review of Charges 2021-27. They will provide the Commission's views on:

- Strategic issues facing the industry that will impact levels of service beyond the next regulatory control period;
- The prospects for customers' charges during the next regulatory control period;
- Issues that directly and materially impact the charges that customers will pay in the next regulatory control period;
- The potential for Scottish Water to engage even more effectively with its customers; and
- The approach to the Strategic Review of Charges 2021-27.

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review¹, taking account of all the evidence available to it in coming to the views set out in these Initial Decision Papers.

In line with the Cooperation Agreement signed with Scottish Water and Citizens Advice Scotland, the Commission would be minded to adopt a business plan that is consistent with the Commission's Final Decision Papers and agreed with the Customer Forum as its Draft Determination.

This tenth Initial Decision Paper sets out the Commission's current view on the prospects for operating expenditure and the levels of service delivered to customers through this expenditure.

Key messages

Customers rightly expect Scottish Water to deliver increasingly better value for money. Since its creation in 2002, Scottish Water has improved its year on year operating performance. After initial reductions of around 30%², operating costs have remained broadly stable since 2006 despite significant upward pressures from new investment, rising input costs and legislative changes. At the same time, service levels have improved and overall performance has risen rapidly to match that of the better UK companies.

Our ongoing benchmarking of Scottish Water's operating cost performance with the England and Wales companies ensures customers continue to receive value for money. The initial indications from this analysis are that Scottish Water is amongst the better performers.

Going forward, we remain of the view that Scottish Water could reasonably be expected to continue to maintain its operating costs broadly flat in real terms, absorbing new costs through efficiency savings. We would expect Scottish Water, through its Business Plan and in its discussions with the Customer Forum and the Commission, to set out a logical case for its operating cost proposals and to provide convincing evidence that it is continuing to improve its efficiency.

¹ Innovation and Collaboration: future proofing the water industry for customers', published on 10 April 2017 and available on the Commission's website.

² Relative to CPI, equivalent to almost 40% relative to RPI.

Initial Decision Paper 10: Operating expenditure

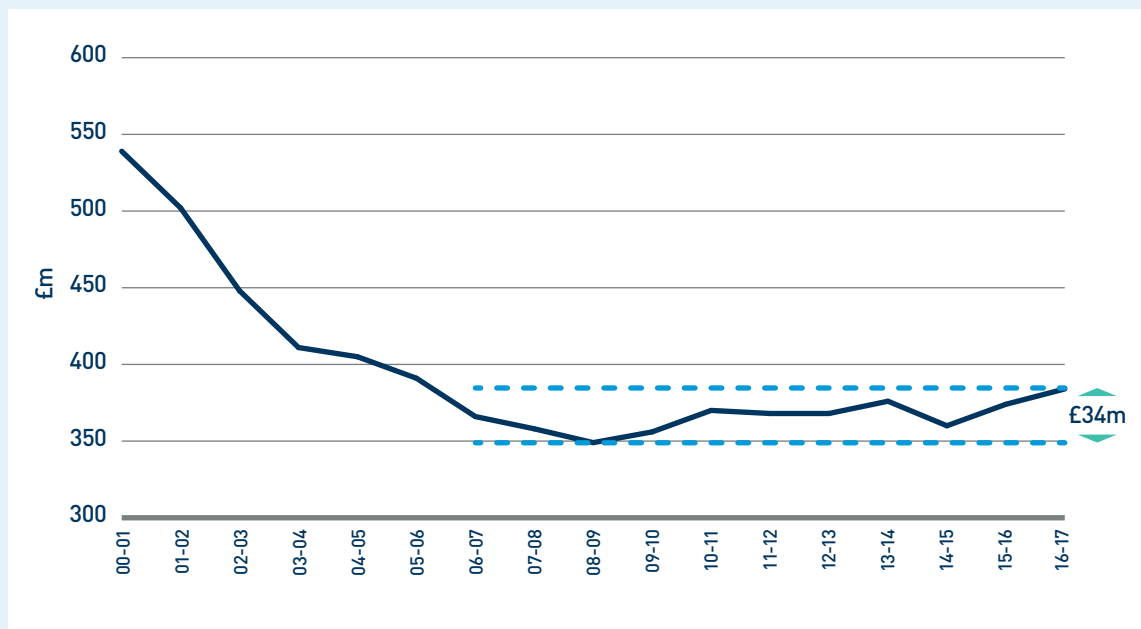
There is a close link between operating costs and service levels. While there may be limited scope for further reductions in operating costs, there may be scope for improvement in efficiency through the delivery of better levels of service, particularly in the small number of areas where Scottish Water appears to perform less well.

Historical Performance

Scottish Water was established in 2002 in a merger of the three former Water Authorities³. The benefits of this consolidation were immediately visible. They included significant operating cost reductions and improvements in the levels of service. By 2006, operating costs were over 30% lower than they had been in 2000, bringing them broadly into line with those of Scottish Water’s peers south of the border.

However, Scottish Water’s levels of service still lagged those of most companies in England and Wales. Scottish Water continued to improve its relative efficiency by improving its levels of service. Scottish Water has also absorbed the impact of higher operating costs associated with the large investment programme (‘new operating costs’) and the additional costs resulting from changes in legislation. Since 2006 operating expenditure has remained relatively flat in real terms, moving within a range of £34 million (equivalent to less than +/- 5% around the average). Figure 1 shows Scottish Water’s performance.

Figure 1. Scottish Water’s operating expenditure excluding PFI (2016-17 prices, on a CPI basis)



Ensuring value for money

Customers want to be assured that Scottish Water continues to seek opportunities to make its operations more efficient.

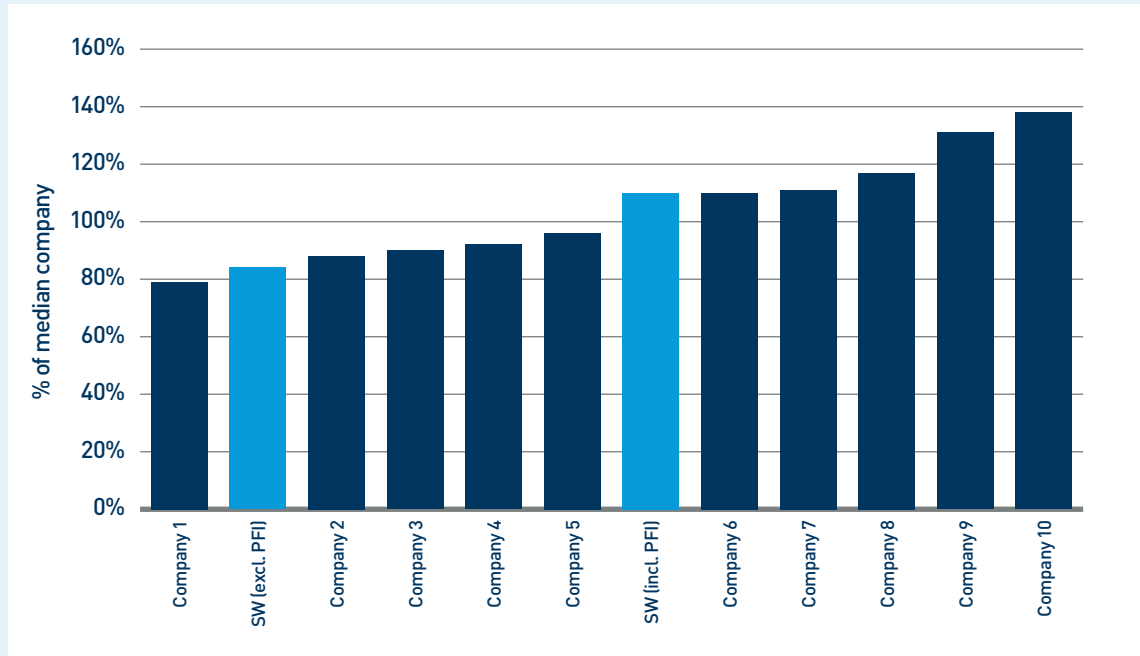
Scottish Water should provide evidence that it continues to perform well when matched against its peers and that it is setting itself stretching targets.

We are working with Scottish Water to update the benchmarking analysis that we completed for the last price review. The initial indications are that Scottish Water remains ‘in the pack’ on operating costs when PFI costs are included. Figure 2 sets out the initial results of our analysis.

³ North of Scotland Water Authority, East of Scotland Water Authority and West of Scotland Water Authority.

Initial Decision Paper 10: Operating expenditure

Figure 2. Initial benchmark analysis of controllable unit operating costs as a percentage of the median company



Scottish Water should seek to widen the scope of its analysis. It could, for example, look at its performance over time using a range of econometric models. This could include consideration of the changes suggested by the Competition and Markets Authority to Ofwat’s models from its last price reviews. Scottish Water’s analysis will help provide the Commission and customers with a better understanding of the scope for further cost reductions. Scottish Water should also set out clearly any upward pressures on costs that it expects to face and, of course, reductions in costs that will help keep overall costs down.

Scottish Water should also seek to explain any proposed trade offs between operating costs and capital expenditure in order that robust year on year comparisons can be made (for both capital expenditure and operating costs).

It will be for Scottish Water to demonstrate that it is setting itself an appropriate challenge. However, at this early stage in the Strategic Review Process, the Commission remains of the view that it is reasonable to expect that operating costs will remain broadly flat in real terms. This would require Scottish Water to continue to drive down operating costs in real terms, through absorbing the new costs arising from the investment programme and also the impact of changing to a CPI based operating cost allowance (rather than the previous RPI). Scottish Water will need to convince the Customer Forum, the Commission and other stakeholders that their proposals are sufficiently ambitious.

Levels of service

Customers will expect Scottish Water to seek out cost reductions and to continue to improve the service it provides to customers, communities and the environment.

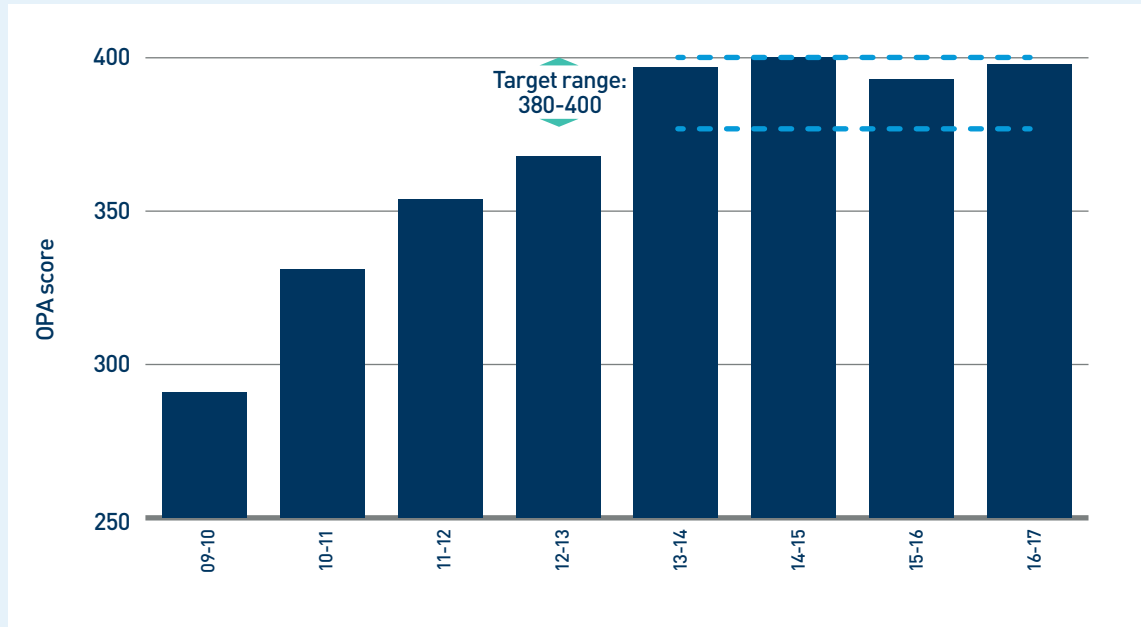
The traditional industry standard Overall Performance Assessment (OPA) measure has been a useful tool for monitoring Scottish Water’s performance across a wide range of service areas (including drinking water quality, environmental compliance, and customer service). Until 2011, this measure was also published for the companies in England and Wales, allowing Scottish Water’s performance to be benchmarked against that of the best performing companies south of the border.

10

Initial Decision Paper 10: Operating expenditure

Scottish Water's year on year OPA score relative to the England and Wales companies improved consistently. In recent years, its scores have been broadly consistent with the top scores ever achieved by companies in England and Wales. Since 2013-14, OPA scores have consistently been at the upper end of the 380 to 400 range agreed for the 2015-21 regulatory period.

Figure 3. Scottish Water's OPA score



We recognise Scottish Water's achievement in maintaining such a high level of performance. This was quite rare south of the border when Ofwat assessed annual performance – only Wessex Water consistently scored highly. However, we consider that there may be areas where customers could reasonably expect to see improvements in service levels. For example, Figure 4 shows some selected areas where Scottish Water's performance appears to have scope for improvement.

Initial Decision Paper 10: Operating expenditure

Figure 4. Scottish Water's performance compared to the England and Wales companies across selected service areas

2015/16		Better than median performance	Matches median performance	Below median performance
Environment	WWTW compliance with numeric limits			•
	Total pollution incidents per 10,000 km		•	
	Serious pollution incidents per 10,000 km		•	
	Self-reporting of pollution incidents			•
Water	Drinking Water Quality (Mean Zonal Compliance)			•
	Low Pressure	•		
	Unplanned interruptions - more than 6, 12 & 24 hours	•		
Waste Water	Properties flooded in the year (overloaded sewers)			•
	Properties flooded in the year (other causes)		•	
	Total number of gravity sewer collapses			•
	Total number of sewer blockages		•	

For the current regulatory period, Scottish Water worked closely with the Customer Forum to develop the 'Customer Experience Measure' (CEM) to provide a broader view of performance for both household and business customers. Although it is still relatively early days for this new measure, we welcome the fact that Scottish Water's CEM score is reflecting ongoing improvements in performance. Similarly, on the UK Customer Satisfaction Index⁴ (UKCSI), Scottish Water has scored relatively highly against its industry peers.

The Customer Forum may wish to discuss with Scottish Water, SEPA and DWQR the scope for further service level improvements. Scottish Water should consider these service levels when it completes its analysis of its efficiency and the challenges that it should bring forward in its business plan for the coming regulatory control period.

⁴ Also referred to as the 'High Esteem Test'. Scottish Water's UKCSI score has improved from 69.9 in July 2016 to 74.5 in July 2017, putting it in the 20 most improved organisations over one year.