Investment and asset management report 2003-06

PERFORMANCE

Overview

This report examines Scottish Water's progress during 2003-04 to 2005-06 in delivering investment objectives to improve water quality, environmental performance and customer service.

Contact
Katherine Russell
Director of Corporate Affairs and Customer Service
T 01786 430200 **E** enquiries@watercommission.co.uk

water industry commission FOR SCOTLAND

Contents

CONTENTS

More detailed findings in relation to Scottish Water's investment performance are available on the Commission's website at www.watercommission.co.uk

INTRODUCTION

Introduction

Context

A key part of our role is to monitor and report on Scottish Water's performance in delivering Ministers' objectives for the water industry in Scotland.

This report examines Scottish Water's progress during 2003-04 to 2005-06 in delivering the investment objectives to improve water quality, environmental performance and customer service[1].

Associated documents

- 'Investment and asset management report 2003-06: Detailed findings', Water Industry Commission for Scotland, October 2006.
- 'Investment and asset management report 2002-03', Water Industry Commissioner for Scotland, November 2004.
- 'The Strategic Review of Charges 2002-06', Water Industry Commissioner for Scotland, November 2001.
- 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

[1] Ministers set these objectives through the Quality and Standards process.

Key messages

KEY MESSAGES

Introduction

Each year, Scottish Water spends around £500 million on maintaining and improving its network of pipes, reservoirs and treatment works. This accounts for about half of Scottish Water's total yearly expenditure.

The money is directed towards particular outputs that will improve drinking water quality, provide cleaner beaches and rivers, and bring better service for customers. These outputs are decided by Scottish Ministers, through a process called 'Quality and Standards', whereby Ministers issue Directions to Scottish Water. Delivery of the outputs is monitored by the Drinking Water Quality Regulator (DWQR), the Scottish Environment Protection Agency (SEPA) and the Commission.

Scottish Water's progress in delivering outputs

To date, Scottish Water has delivered nearly 90% of the outputs that it was required to deliver during the 'Quality and Standards 2' investment period (which covered 2002-06). It has, for example, made significant progress in:

- replacing worn out mains and sewers;
- reducing the number of sewerage overflows that perform in an unsatisfactory way; and
- improving water supply pressure to properties.

Completing the programme of work will provide further benefits for water quality and environmental performance, as well as increasing the number of properties that receive water and sewerage for the first time and reducing the occurrence of flooding from sewers.

The benefits for customers of this work are already being noted. The DWQR, for example, stated that during 2005 "compliance with the drinking water quality standards improved". Similarly, SEPA has remarked that "all of Scotland's bathing beaches have passed the European standard water quality tests for the first time since monitoring began 20 years ago"[2]. These reported improvements provide clear indications that the investment which customers are paying for is bringing benefits for this and future generations.

Ensuring that the full programme is delivered

Some of the outputs that Scottish Water was required to deliver have met with delays and have not yet been completed. In part this was because the investment got off to a slow start in the early years of the Quality and Standards 2 programme. It took some time for Scottish Water to set up the contracts to deliver the programme. The pace of delivery did increase, however, in the later years, with Scottish Water managing to deliver record levels of investment in the final two years of the programme (ie 2004-05 and 2005-06).

[2] DWQR's Annual Report, 'Drinking Water Quality in Scotland 2005' (9 August 2006) and SEPA's press release 'Full marks for Scotland's bathing waters' (15 September 2006).

KEY MESSAGES

It has been agreed by Scottish Ministers as a general principle that customers should not pay twice for the same outputs. In the light of this, Scottish Water will not be able to charge customers for any extra costs that result from the delays in delivering the remaining outputs. If Scottish Water incurs additional costs due to inflation in delivering the rest of the programme, it will need to finance this through its own increased efficiency. Scottish Water has made a clear commitment that it will deliver all of the outputs for the next Quality and Standards period (2006-10), including the outputs outstanding from the last period, for the revenue and borrowing that was allowed for in the Commission's final determination of charges 2006-10.

The 'sign-off process'

There is a detailed process, agreed last summer, whereby the DWQR and SEPA confirm that Scottish Water has delivered the required outputs. This process includes site visits where necessary. There is currently a significant shortfall between the number of outputs that Scottish Water states are complete and the number that have been formally signed off.

The Commission has raised concerns with Scottish Water and the quality regulators about delays in the sign-off process. It has been reassured that measures have been put in place to address the backlog of projects that require sign off. The Commission will, of course, continue to monitor progress closely.

Going forward

Lessons have been learned from the Quality and Standards 2 programme. Going forward, the focus will be on monitoring delivery of outputs (that is, the benefits to customers) rather than inputs (for example, money spent).

Clearly customers need to know that they have received the benefits of the investment that they pay for through bills. Monitoring the benefits to customers is the most effective way to monitor investment delivery. This is because simply spending money is no guarantee that benefits will be delivered; similarly, reduced spending could be an indication of greater efficiency, rather than of a failure to deliver an output.

In future, the delivery of outputs will be monitored by the Output Monitoring Group. This group was established by Scottish Ministers, working closely with the Commission. It is made up of representatives from Scottish Water, the DWQR, SEPA, the Scottish Executive, Waterwatch (the customer representative) and the Commission. The group meets quarterly to review Scottish Water's investment performance.

The Output Monitoring Group is looking at ways to measure progress that will highlight any potential shortfalls in performance. The next 'Investment and asset management report' will report on the findings of the group, and provide the latest state of play on the investment programme.

Assessment of investment performance

Monitoring investment performance

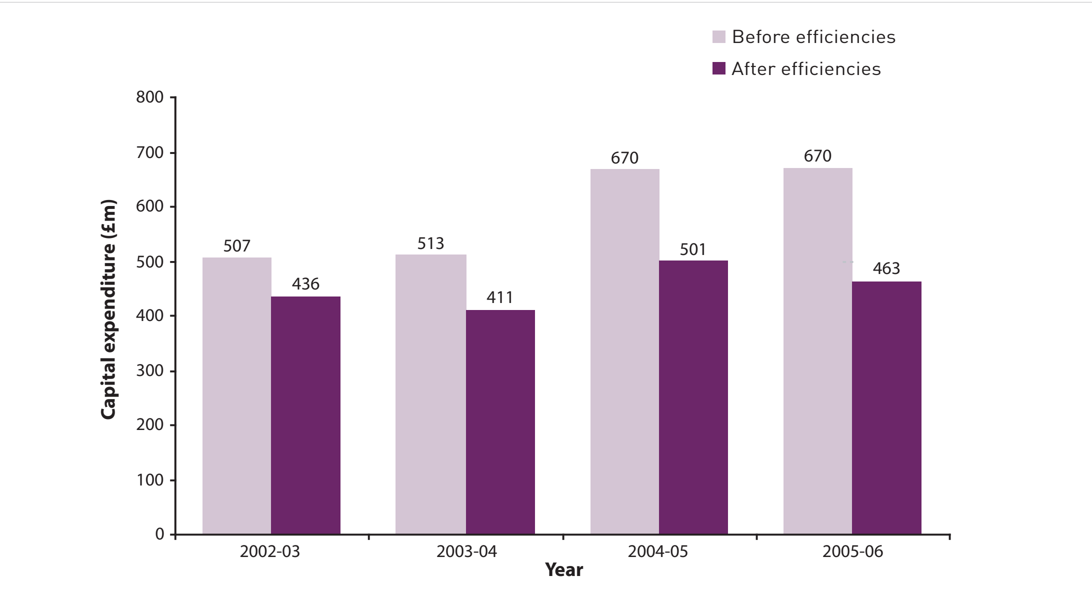
Each year, Scottish Water supplies the Commission with detailed information on its performance in delivering the investment programme. This includes information on progress in achieving the objectives set by the Scottish Ministers through the 'Quality and Standards' process.

Progress is measured against a set of defined outputs which, when fully delivered, will provide higher standards of drinking water, cleaner rivers and beaches, and better service to customers.

Expenditure on Quality and Standards 2 outputs

The 'Quality and Standards 2' investment programme ran from 1 April 2002 to 31 March 2006. At the Strategic Review of Charges 2002-06 (published in November 2001), the programme was costed at more than £2.3 billion[3], before taking account of the scope for capital efficiency in delivering the programme. Once the former Water Industry Commissioner's efficiency targets had been applied, Scottish Water was required to deliver the investment outputs for £1.8 billion. Figure 1 shows the projected expenditure both before and after the efficiency targets.

Figure 1: The allowed for investment on Quality and Standards 2 outputs (before and after efficiency targets)



During the Quality and Standards 2 period, the Commissioner agreed adjustments to the investment that he had allowed for in November 2001. These adjustments reflected higher than expected inflation and the cost of some additional outputs, including new legislative requirements on health and safety and increased site security. As a result, the efficient cost of delivering the revised Quality and Standards 2 outputs increased from £1.8 billion to almost £2.1 billion. Figure 2 shows the capital expenditure allowed for in the Strategic Review of Charges 2002-06, and the adjustments since then.

[3] All numbers in this report are in outturn prices unless otherwise stated.

INVESTMENT PERFORMANCE

Figure 2: Adjustments to the investment allowance determined at the Strategic Review of Charges 2002-06

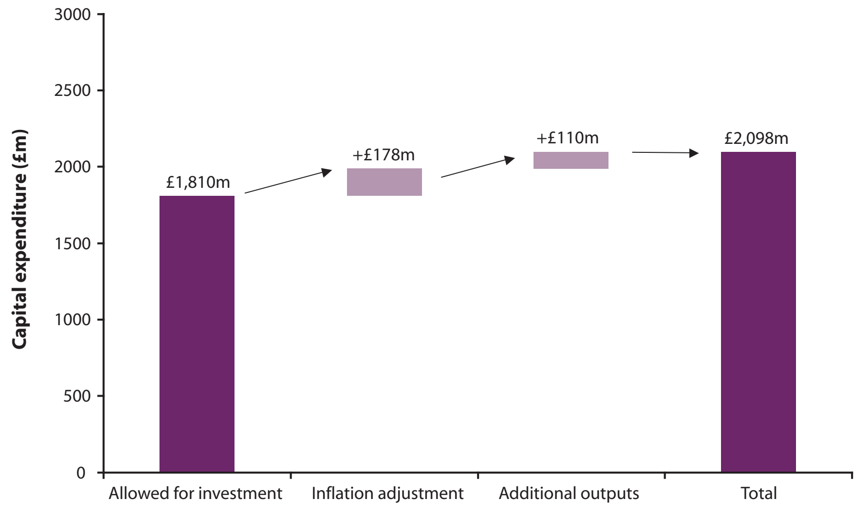
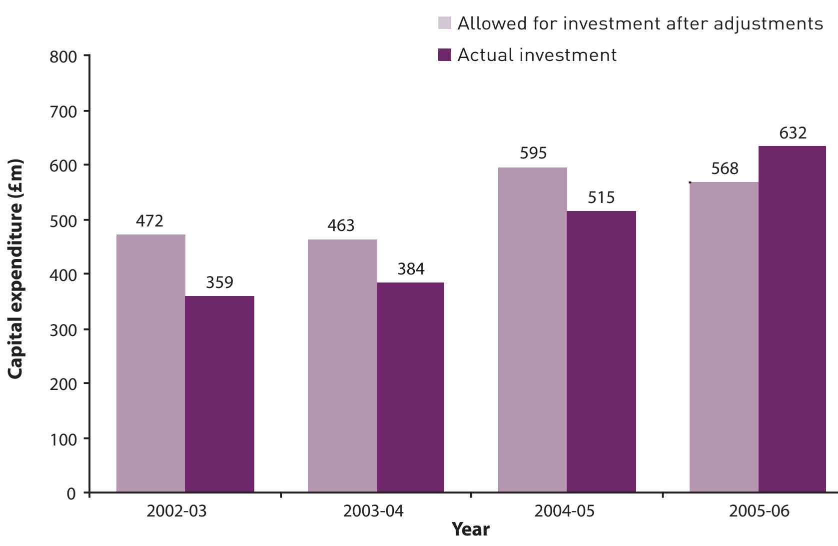


Figure 3 shows the expenditure that was projected in the Strategic Review of Charges 2002-06 (adjusted for inflation and additional outputs), and the actual expenditure undertaken by Scottish Water in the period to 31 March 2006 in delivering the Quality and Standards 2 outputs.

Figure 3: Allowed for and actual capital expenditure to March 2006



Although Scottish Water delivered record levels of investment in the final two years of the programme (ie 2004-05 and 2005-06), some outputs remained to be delivered at the end of the period.

INVESTMENT PERFORMANCE

Progress in delivering outputs

Overall, Scottish Water reports that 86% of Quality and Standards 2 outputs have been completed to what it terms 'beneficial use'. This is the point at which customers receive the benefit of the investment. However, there is a particular shortfall in delivering water quality and environmental improvement outputs. Around 21% of these outputs have yet to reach beneficial use. For example, there is a shortfall in first time sewerage provision, where 290 properties remain to be connected.

The Commission is monitoring delivery of the remaining outputs closely through the Output Monitoring Group[4]. Scottish Ministers, working closely with the Commission, established this group. It is made up of representatives from Scottish Water, the Drinking Water Quality Regulator (DWQR), the Scottish Environment Protection Agency (SEPA), the Scottish Executive, Waterwatch (the customer representative) and the Commission. The group meets quarterly to review Scottish Water's investment performance.

Water quality and environmental improvement outputs must be formally signed off as complete either by the DWQR or by SEPA. There are 1,164 such projects. At the end of the 2002-06 regulatory control period, 24% of these projects had been signed off. Scottish Water, the DWQR and SEPA have assured the Commission that the sign-off process will be accelerated.

Financing delivery of the remaining outputs

Scottish Water invested £1,890 million on Quality and Standards 2 in the period to March 2006. In the final determination[5], the Commission allowed the £274 million that Scottish Water said in its 2005 business plan was required to deliver the remaining Quality and Standards 2 outputs[6].

Scottish Water currently forecasts that it will spend £279 million to deliver the remaining outputs[7]. This implies total investment of £2,168 million, some £71 million more than the £2,098 million efficient cost. Scottish Water also forecasts that it would receive contributions, mainly from developers, of £20 million towards these costs. Scottish Water therefore forecasts that it would spend around £51 million (2%) more than the revised allowance for Quality and Standards 2 outputs.

The Commission is pleased that, in their statement on charges, Scottish Ministers confirmed the view expressed in the methodology for the Strategic Review of Charges 2006-10 that customers should not pay twice for Quality and Standards outputs. In the light of this ministerial statement, the Commission did not allow for any additional capital inflation on the outputs that remain to be delivered. This means that if there is any capital inflation during the period when Scottish Water delivers the remaining Quality and Standards 2 outputs, Scottish Water will need to deliver the remainder of the investment programme for 2006-10 more efficiently than was assumed in the final determination.

[4] The Output Monitoring Group replaced the Capital Monitoring Group, which was previously responsible for monitoring investment performance.
[5] 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.
[6] As the report goes on to explain, the Commission did not allow for the additional costs associated with capital expenditure inflation.
[7] This information was provided by Scottish Water in its June 2006 Annual Return.

INVESTMENT PERFORMANCE

In this regard, the Commission has noted that in its delivery plan, Scottish Water has committed to deliver all of the outputs specified in the final determination, including the remaining Quality and Standards 2 outputs, within its overall allowance.

At the current time, the Commission estimates that Scottish Water would have to deliver the remaining outputs of this regulatory control period some £10 to £25 million more efficiently to compensate for the higher than forecast costs incurred in delivering the remainder of the Quality and Standards 2 outputs.

An independent Reporter examines Scottish Water's information submissions to the Commission. He commented that there are significant uncertainties in Scottish Water's current forecast of the cost of delivering the remaining outputs.

The Commission considers that the following factors appear to have increased the challenge of delivering the outputs required by the final determination within the available budget:

- capital inflation beyond 2005-06;
- under-delivery of financed outputs, for example for first time sewerage provision; and
- because additional spending that was made available for new outputs has not been spent.

There are other risk factors that could further increase the additional efficiency challenge faced by Scottish Water. These factors are difficult to quantify at this stage; however, they could increase the challenge facing Scottish Water from around £10 million to around £90 million[8].

The potential risks identified by the Commission are not necessarily inconsistent with the commitment made by Scottish Water to deliver the full investment programme by 2009-10.

Looking forward

The Commission will report on Scottish Water's performance in the next 'Investment and asset management report', which is due to be published in October 2007. The report will take account of the findings of the Output Monitoring Group.

[8] It should be noted that the ranges shown here are the Commission's assessment of the potential risk based on the best available information at this time.

18.10.06

Water Industry Commission for Scotland
Ochil House, Springkerse Business Park, Stirling FK7 7XE.
T 01786 430 200 **F** 01786 462 018 **E** enquiries@watercommission.co.uk
www.watercommission.co.uk