

Investment report 2007-08

PERFORMANCE



Overview

This report examines Scottish Water's progress during 2007-08 in delivering investment outputs to improve water quality, environmental performance and customer service.

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INTRODUCTION

Context

Investment in maintaining and improving the assets to provide water and sewerage services accounts for around half of the money that Scottish Water spends each year. The investment programme is designed to deliver significant environmental, drinking water quality and customer service improvements as well as ensuring that Scotland's network of pipes and treatment works has sufficient capacity to respond to growth.

We are determined to make sure that customers receive value for money from Scottish Water. For much of the investment programme that Scottish Water is expected to deliver, the Drinking Water Quality Regulator (DWQR) or the Scottish Environment Protection Agency (SEPA) are asked to confirm if required outputs have been delivered. Achieving this 'sign-off' is critical. It is only at this point that customers can be assured that they will receive the benefits they have paid for.

We therefore continue to put particular emphasis on the sign-off of outputs, where relevant, as confirmation of satisfactory output delivery.

Scottish Water's overall progress on investment delivery is monitored by the Scottish Government-chaired Output Monitoring Group (OMG). This group is made up of representatives from SEPA, DWQR, Waterwatch Scotland, Scottish Water, the Scottish Government and us. We provide analytical support to the group. This report summarises our view of Scottish Water's performance in 2007-08 based on our analysis of all Scottish Water's regulatory information.

Associated documents

- 'Investment report 2006-07', Water Industry Commission for Scotland, October 2007.
- 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

KEY MESSAGES

How Scottish Water performed in 2007-08

Although Scottish Water increased its spending and delivery towards the end of 2007-08, the year covered by this report, we remain concerned about the rate at which projects are being submitted for sign-off¹.

In 2006, and with a later revision in 2007, Scottish Water produced a delivery plan setting out when it proposed to deliver outputs and achieve the key milestones leading up to delivery. At the end of this, the second year of the four-year investment programme (which runs from 2006 to 2010), Scottish Water is behind the sign-off target for half of the quality improvement outputs.

Scottish Water also forecasts that some of the expected benefits from the investment programme will be delayed beyond the end of the current investment period in March 2010. In addition, a small number of key projects from the previous investment programme (2002-06), including works at Campbeltown and Invergordon, continue to be delayed. As a result, customers are having to wait longer for the benefits promised to them.

These delays will also impact on Scottish Water's costs and increase the efficiency challenge that it must meet. This is because the longer delivery is delayed, the greater the potential impact of inflation on costs. Customers should be reassured, however, that they will not have to pay any more as a result of any shortfall in Scottish Water's performance. This is because, in 2005, we set Scottish Water a firm budget for delivering its investment programme and placed caps on the amount it could charge customers in each year between 2006 and 2010. If Scottish Water goes over budget, it cannot increase customer charges to pay for this cost overrun.

We also monitor Scottish Water's performance against the targets we set for reducing leakage of water from its network. In 2007-08 Scottish Water did not meet our leakage reduction target for the second year running.

We have increased our monitoring of leakage performance and are working with Scottish Water to derive a better assessment of its economic level of leakage – the point at which the full cost of reducing leakage is the same as the cost of the water lost. However, whilst we will continue to monitor progress carefully, Scottish Water must deliver the improvements needed to reduce leakage to acceptable levels.

We welcome the improved monitoring of Scottish Water's investment delivery through the multi-stakeholder Output Monitoring Group. Going forward, we are developing further measures to ensure that Scottish Water's progress in delivering the outputs that customers have paid for is clear. Earlier this month (October 2008) we reported on the success of the single overall performance assessment (OPA) measure in driving improvements in customer service. We are now seeking to establish a similar single measure for output delivery.

¹ The Scottish Environment Protection Agency (SEPA) signs off environmental improvement projects, the Drinking Water Quality Regulator (DWQR) signs off drinking water quality projects, the Scottish Odour Steering Group signs off odour control projects, and the Scottish Government signs off the provision of strategic capacity and the installation of non-domestic metering.

ASSESSMENT OF INVESTMENT PERFORMANCE

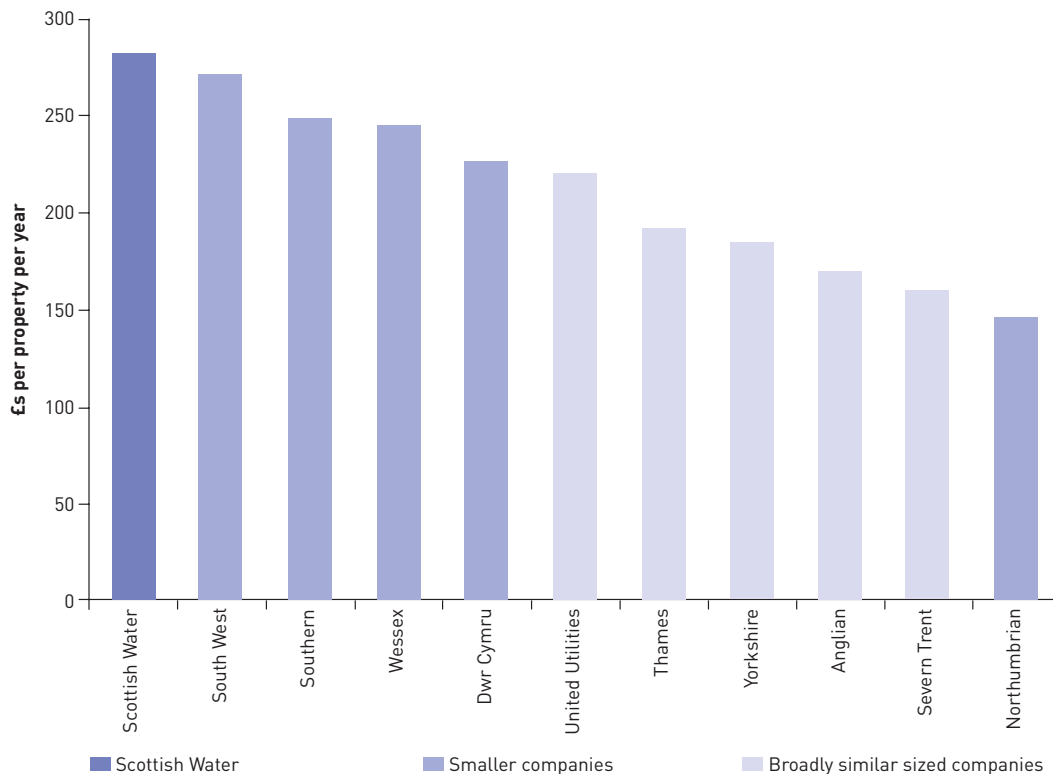
Scottish Water's 2006-10 investment programme

Ministers set Scottish Water objectives to improve water quality, environmental performance, customer service and to respond to growth. Scottish Water's current investment programme is designed to deliver a series of specific outputs that will allow it to achieve these objectives by 2010. These outputs include, for instance:

- improving drinking water quality for 1.5 million customers,
- improving water disinfection control for 4 million customers,
- removing a large number of unsatisfactory discharges from the sewer network, and
- upgrading waste water treatment works to meet compliance requirements.

The investment programme Scottish Water is undertaking to deliver these outputs is the largest in Great Britain (on a per connected property basis). Figure 1 shows the investment per property in Scotland, as compared with the programme of the ten largest water and sewerage companies in England and Wales. Scottish Water's investment programme is much larger than those of companies that are comparable in size (United Utilities, Thames, Yorkshire, Anglian and Severn Trent).

Figure 1: Comparative size of the 2006-10 investment programme (at March 2007)²



² Based on average investment per property per year in 2007-08 prices.

It is important to emphasise that Scottish Water’s investment programme is substantial and, as with any large programme of work, delays and missed targets in the early stages make it very challenging to catch-up on time and keep to budget.

Progress with delivering the investment programme

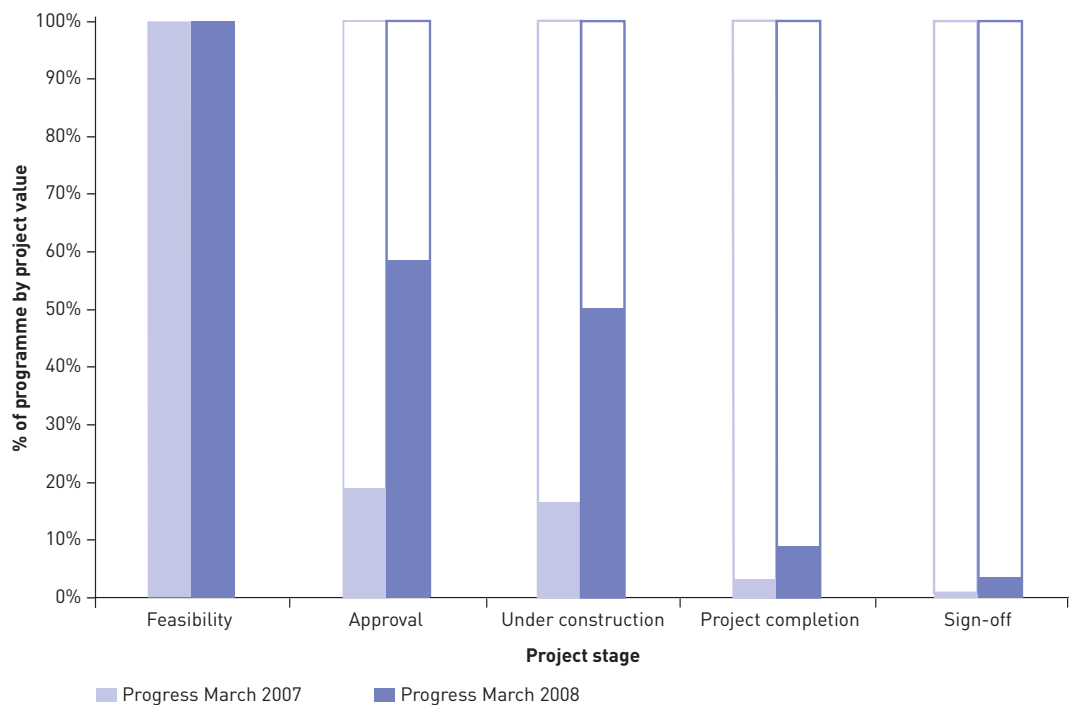
Delivering outputs

We measure Scottish Water’s progress by monitoring the delivery of the outputs of investment (ie the benefits to customers and the environment). For much of the investment, it is only when the quality regulators have signed off projects that customers can be assured that the required outputs have been delivered.

We are concerned about the pace of Scottish Water’s progress in delivering sign-off outputs for customers, which remains behind target. Delivering the remainder of this programme efficiently will be a challenge, and indeed Scottish Water is now forecasting that some of the required outputs will be delivered after the end of the regulatory period in March 2010.

Figure 2 shows in more detail the cumulative progress of Scottish Water’s investment projects (by value) through each step of the five-stage delivery process. Although during 2007-08 Scottish Water increased the value of the programme that had reached the construction stage, relatively little had been delivered to the project completion stage and even less had been signed off by the quality regulators as fit for purpose.

Figure 2: Cumulative progress (by project value) of the 2006-10 investment programme



Scottish Water provides a forecast of its expected progress with the delivery of outputs through each of these milestones. This forecast is used by the OMB to determine where slippage has occurred. Currently, Scottish Water is behind the sign-off target for half of the outputs. Those behind target include improvements in drinking water quality and compliance with standards for waste water treatment works.

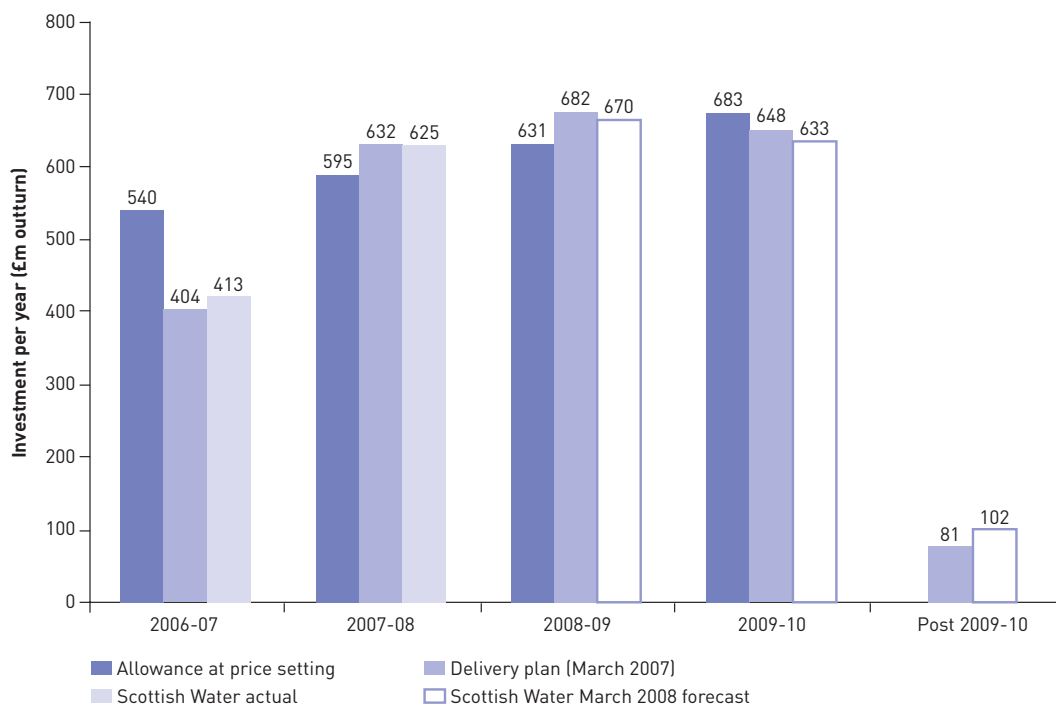
Investment expenditure

Scottish Water incurs investment expenditure when it spends money either to buy fixed assets (such as new plant or machinery) or to add to the value of an existing fixed asset (for example, a water treatment plant) to extend its useful life. While output delivery is our main focus, we also monitor Scottish Water's investment expenditure as a further indicator of progress.

Scottish Water made a slower than planned start to its investment expenditure during 2006-07 (some £127 million less than we allowed for when setting prices in 2005). Figure 3 shows that while Scottish Water increased its investment expenditure during 2007-08, it forecasts that it will need to maintain this high level of expenditure in the final two years of the programme to deliver the outputs.

Scottish Water is also forecasting that it will spend some £102 million after the close of the regulatory period. This means that some of the expected benefits from the investment programme will be delayed beyond the end of the current investment period in March 2010. In addition, a small number of key projects from the previous investment programme, including works at Campbeltown and Invergordon, continue to be delayed.

Figure 3: Actual and forecast investment expenditure 2006-10 (outturn prices)



The longer the delays last, the longer customers will have to wait for improvements to be delivered. Delays also mean that there is the potential for future inflation to increase Scottish Water's costs. Customers should be reassured, however, that they will not pay any more as a result of shortfalls in performance. This is because, in 2005, we set Scottish Water a firm budget for delivering its investment programme and placed limits on the amount it could charge customers in each year between 2006 and 2010. If Scottish Water goes over this budget, it cannot increase customer charges to pay for the cost overrun.

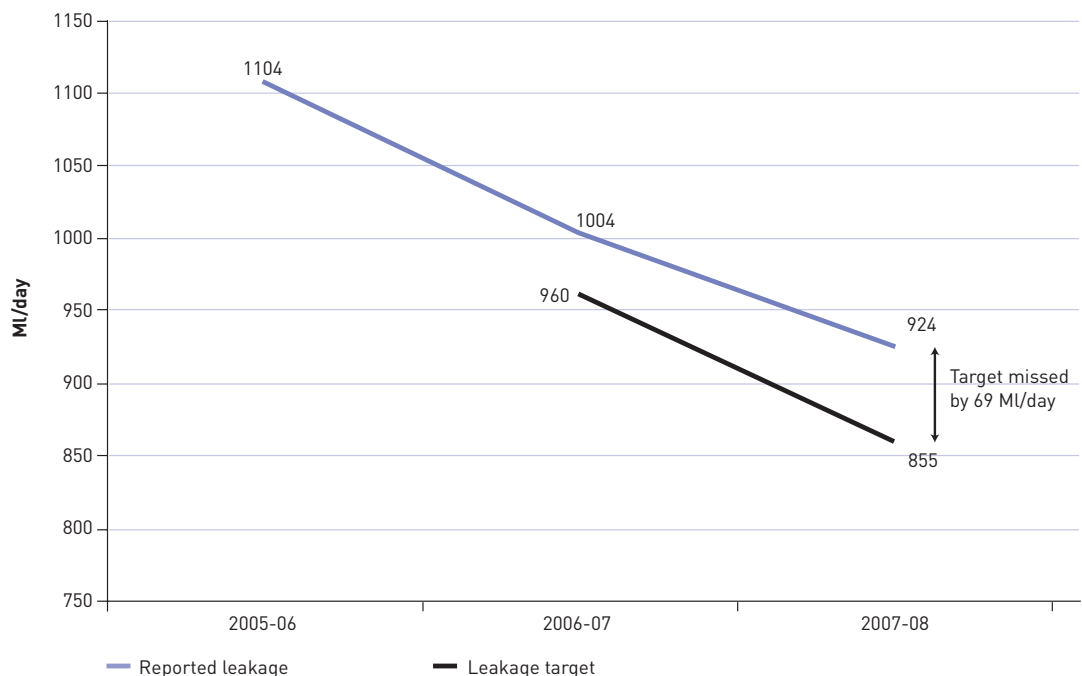
Progress in tackling leakage

Leakage is the water lost in a water network before it reaches customers, and can arise from, for example, bursts in pipes or poor connections.

In 2006 we set Scottish Water pragmatic targets to make annual reductions in its leakage. These pragmatic targets are designed to be a first step towards Scottish Water reaching its economic level of leakage – the point at which the cost of reducing leakage is the same as the cost of the water lost. Scottish Water is financed to move 50% closer to its economic level of leakage by 2010, and we aim to finance it to reach its economic level of leakage by 2014.

Figure 4 shows Scottish Water's performance in addressing leakage in 2006-07 and 2007-08, compared with the target reductions we set in 2006.

Figure 4: Scottish Water's leakage performance



During 2007-08, Scottish Water decreased its reported leakage from 1,004 ML/day to 924 ML/day. However, it fell short of our target which for 2007-08 was 855 ML/day. This is the second year running that Scottish Water has missed our leakage target. Indeed, it has missed the target by more than in 2006-07 in both absolute and percentage terms.

Although Scottish Water is beginning to make progress, leakage is still much too high.

We have taken steps to help Scottish Water better understand the extent of its leakage through a Regulatory Leakage Group. This group, which includes the independent industry Reporter, has developed an improved management information system for reporting leakage. Scottish Water is due to provide us with a better assessment of its economic level of leakage in December.

While Scottish Water is working with us to improve the way it measures leakage, it must take the practical action necessary to tackle leakage and progress quickly to the economic level. We will continue to monitor Scottish Water's progress carefully.

GOING FORWARD

Scottish Water's recent uplift in investment expenditure suggests that the pace of delivery is increasing. While Scottish Water did increase its spending and delivery towards the end of the reporting year, it needs to increase the rate at which projects are being submitted for sign-off. We are concerned that the early delays in delivering the programme could lead to Scottish Water paying higher prices than would otherwise have been necessary. Customers should be reassured, however, that they will not pay any more as a result of shortfalls in performance.

We will continue to work with the Output Monitoring Group to ensure that outputs are delivered and will report on Scottish Water's performance during 2008-09 in the next 'Investment report', which is due to be published in October 2009.

We will also continue to work to devise a single measure for output delivery. The success of the OPA in driving improvements in customer service suggests that a single measure for investment could be just as effective. We will test the measure in the remainder of this investment period and implement it fully in the next period (2010-14).

Going forward, it will be important to ensure that the investment programme for the next investment period is manageable, affordable and can be delivered efficiently. We commissioned research into the size of investment programmes that can be delivered efficiently. It considered issues such as the capacity of the construction industry and the likely disruption to customers from large investment programmes. The report concluded that a mid-sized programme, averaging approximately £400-£450 million per year is to be preferred over a larger programme. The investment programme that Scottish Water is currently delivering is larger as it includes a significant overhang from the 2002-06 regulatory period. We will be looking to ensure that the investment programme going forward is an appropriate size.

21.10.08



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