ANNUAL REPORT 2007-08

Achieving best value for water and sewerage customers

FOR THE PERIOD 1 APRIL 2007 TO 31 MARCH 2008
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June 2008
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ANNUAL REPORT 2007-08

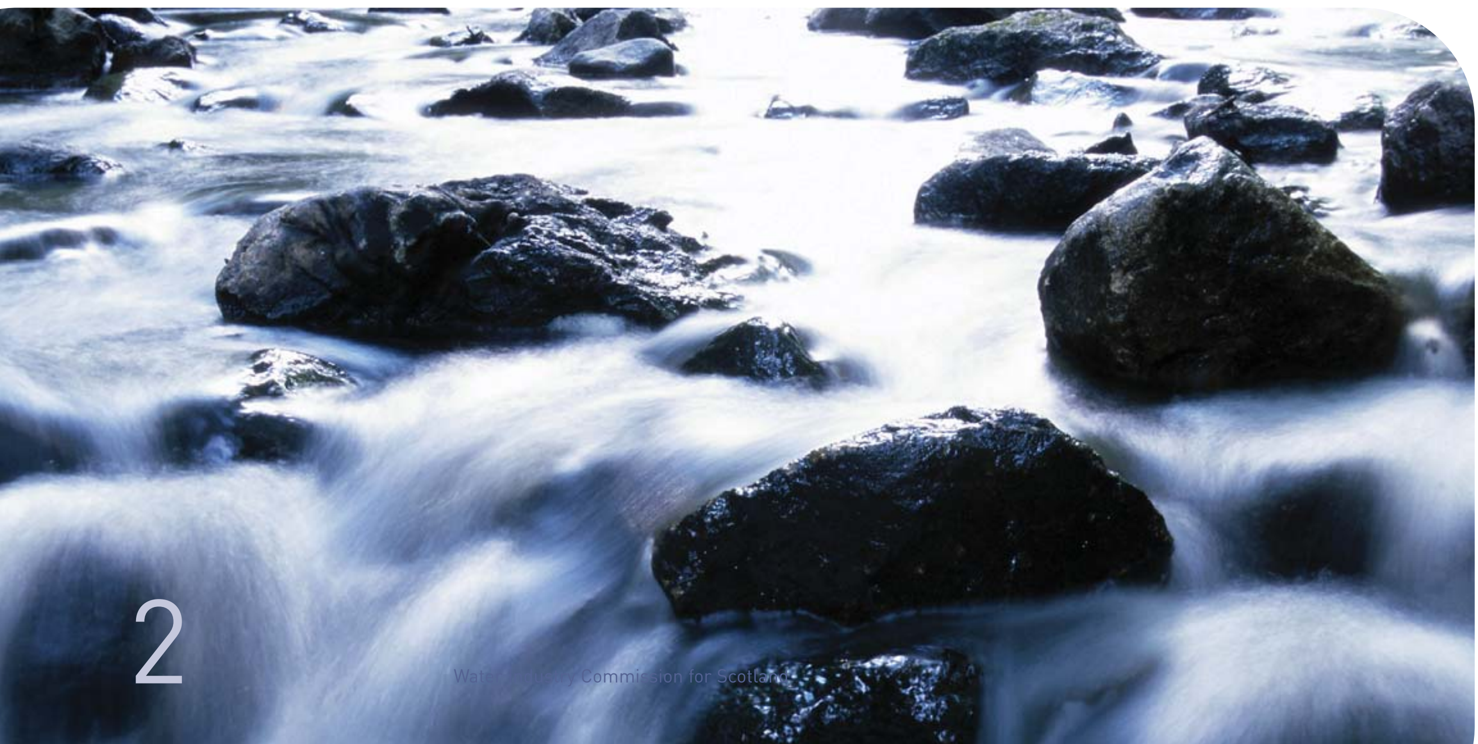
Our work for customers: the Water Industry Commission for Scotland

The Water Industry Commission for Scotland (WICS) is the economic regulator of the Scottish water industry. We have a statutory duty to promote the interests of customers.

We aim to ensure that customers get the very best value for money from their water and sewerage service.

We do this by:

- **regulating prices** for household customers and wholesale charges for suppliers to ensure that they represent value for money;
- making sure that Scottish Water delivers for customers by **monitoring progress**; and
- facilitating lower prices, better services and more innovation through introducing **competition** for business customers and public bodies.



The Commission and staff

WICS is a non-departmental public body, established by statute in 2005. The Commission comprises a non-executive Chairman, a deputy Chairman and three non-executive members. The Chief Executive is also a member of the Commission.

Back row (from left) Professor John Banyard, Dr Mike Brooker, Charles Coulthard.
Front row (from left) Alan Sutherland, Sir Ian Byatt, Professor David Simpson.

Members of the Commission:

- Sir Ian Byatt, Chairman
- Professor David Simpson, Deputy Chairman
- Professor John K Banyard OBE, non-executive member
- Dr Mike Brooker, non-executive member
- Charles Coulthard, non-executive member
- Alan Sutherland, Chief Executive.

A team of staff of around 25 people put the Commission's strategy into practice. The team is headed up by our directors:

- Katherine Russell, Director of Corporate Affairs and Customer Service, and Secretary to the Commission
- Dr John Simpson, Director of Analysis
- Ian Tait, Director of Investment
- Dr Jeremy Atkinson, Director of Competition[1].

1. Jeremy Atkinson left WICS during 2007-08 to become Chief Executive of the Central Market Agency.

An important year for customers

Significant changes took place in the Scottish water industry in 2007-08. These changes should benefit all water and sewerage customers in Scotland.

At the close of this year, Scottish businesses and public bodies became the first in the world to be able to choose their water and sewerage supplier:

"Scotland is leading the world with the introduction of a competitive framework for the water and sewerage sector.... any company or public body, of any size, from the smallest corner shop to an international conglomerate, stands to benefit from these changes."

Alan D A Sutherland, WICS Chief Executive

Scottish Water continues to operate all wholesale supplies and serve household customers. It made significant improvements:

"Scottish Water has reduced its operating costs for five years in a row. At the same time it has improved its service to customers. These lower costs are bringing substantial savings for customers."

Sir Ian Byatt, WICS Chairman

Chairman's foreword

Our main activity this year has been to help businesses and public services in Scotland, by offering them a choice of supplier of retail water and waste water services. This builds on the limitation to annual price increases of 1.5% below retail price inflation that we set in 2005 for these customers for the four years from 2006 to 2010.

This choice of supplier – a world first for Scotland – is already showing benefits to business customers through lower prices and better services. As this becomes better known, we expect public bodies, such as schools and hospitals, also to improve the management of their water use.

The suppliers, which include Business Stream (the retail arm of Scottish Water), will provide water and waste water services, including advice on how to make better use of this valuable resource. Scottish Water will continue to supply the water itself and take away waste water under price controls set by the Commission. Customers will continue to be protected as all suppliers will be obliged to offer a 'default' tariff, related to the controlled wholesale price. But they can now look for better deals.

We will report annually, each autumn, on progress in this market by adding a fourth report to our regular reports, namely on Scottish Water's customer service, its costs and performance and the delivery of its investment programme.

The Commission succeeds when Scottish Water delivers good and economical services to its customers and to the environment. Household water bills in Scotland are now below the average south of the Border. Scottish Water's service to its customers has improved significantly over the year, and this can be expected to continue. It has kept operating costs below the expectations set when price limits were determined; if this continues, customers can gain from lower prices in the next period of price controls, ie from 2010 to 2014.

Scottish Water's performance indicates that the clear incentive framework that is in place to regulate the water industry is serving the interests of customers well.

Performance on its investment programme remains to be demonstrated. After a slow start last year, Scottish Water has significantly increased its capital expenditure. But the key issue is the delivery of better service to customers and the environment. We will continue to put special emphasis on the sign-off of projects by the quality regulators.

During the previous regulatory period, developers claimed that reluctance on the part of Scottish Water to connect new properties, both household and non-household, had created constraints on development. We were careful to ensure that the current price limits allowed for sufficient expenditure to deal with this and are now glad to report that this issue appears to be resolved. While there may still be constraints on development, they do not seem to result from water issues. There remains, however, a need to ensure proper co-ordination between the various participants in the case of large-scale developments, such as the Clyde Gateway and the A96 corridor at Inverness.

Licences have been granted to suppliers, ranging from Business Stream through specialist suppliers to large companies operating south of the border. The new arrangements should pay for themselves from savings in Scottish Water and Business Stream – before any allowance is made for the considerable savings that customers should be able to make from the introduction of competition in this segment of the market.

As a body with its own statutory powers, the Commission has taken steps to visit and inform Members of the Scottish Parliament, local authorities throughout Scotland, and Scottish trade and business associations as part of its programme for accounting to the Scottish people.

Looking forward, I have previously expressed concern – from the point of view of paying customers – about the availability of finance for Scottish Water's very large investment programme. In this context, the Commission has welcomed the Scottish Government's consultation on a Scottish Futures Trust. If set up and resourced appropriately this could be to the advantage of customers, through developing best practice in both procuring and financing capital projects.

The Commission is engaged on preparation for the setting of price limits for Scottish Water's household customers, wholesale prices and for the 'default' tariff for suppliers for the years from 2010 to 2014. All interested parties are being systematically consulted. Subject to continuing increases in efficiency by Scottish Water and the establishment of a manageable programme of capital investment, the Commission so far sees no reason for movement away from the lower than inflation price increases for customers currently being enjoyed. Such an outcome would be good for customers in Scotland and for the competitiveness of Scottish business.

We are also preparing for other eventualities, such as the possible abolition of Council Tax and the substitution of a Local Income Tax. This could prove an opportunity for the extension of retail competition to household customers. We are also considering, in parallel with the investigation being carried out by Professor Cave in England and Wales, how competition may be further extended in wholesale water and sewerage services.

In conclusion, we believe that we can report to the Parliament that we have been effective in pursuing the interests of people in Scotland. This has involved considerable effort by the staff of the Commission and I want to take this opportunity to thank all those in the Office who have worked so creatively and effectively to design and to implement our policies.

Sir Ian Byatt
Chairman
25 June 2008

Chief Executive's review

Opening up the market in Scotland was perhaps the most significant change in the water industry in Great Britain for some 20 years. Competition will help ensure that customers see further significant improvements in value for money.

Real choice arrives for Scottish customers

This year saw perhaps the most significant change ever to affect the water and sewerage industry in Scotland – the arrival of competition. Business customers and public bodies in Scotland were the first, anywhere in the world, to have such a genuine opportunity to choose their water and sewerage supplier. All organisations in Scotland – from the smallest newsagent in the Western Isles to the largest industrial sites in Glasgow; from small council offices to leisure centres and hospitals – can now choose who supplies their water and sewerage services. Customers should benefit from an enhanced level of service and lower bills as a consequence of these new arrangements. There may also be significant environmental benefits.

Creating the arrangements for competitive entry into the retail market for business customers has involved intense innovative work. A Central Market Agency, to be owned by suppliers, has been created; operating and market codes have been worked out; a procedure for timely issue of licences to suitable entrants has been devised; and steps have been taken to inform business customers of the new opportunities, including creating a new website, www.scotlandontap.gov.uk.

In the run up to 1 April 2008 we considered the applications of, and awarded licences to, four licensed suppliers: Aquavitae, Business Stream, Osprey and Satec. We have since awarded further licences to Ondeo. We expect to license more entrants, ranging from the small to the very large. The new suppliers buy wholesale services (the physical supply of water and removal of sewage) from Scottish Water. They retail these and other services on to business customers and public bodies.

The changes in the industry mark an end to the 'one size fits all' approach. We expect the new suppliers to compete to offer service and price packages that are right for individual customers. Suppliers may offer lower bills, different methods of payment and different levels of response to problems. One of the most obvious potential benefits may be in the provision of advice on water efficiency to customers. Where the retail activity is separated, it is more likely that customers will receive appropriate advice in this area.

There is also provision in law that new suppliers and their customers can benefit if their actions help Scottish Water to reduce its costs. Discounts may be available to organisations that can plan their water use or waste disposal (for example by restricting their use of water at certain times of day); there may also be opportunities for developers to work with Scottish Water and realise benefits. We will shortly publish further detailed information on how a customer who can reduce Scottish Water's costs of providing the service may apply for such departures from the wholesale charges scheme.

We have also put in place measures to ensure that no customer – not a single business or public body – need be worse off as a result of the introduction of competition. We made it a licence condition that all new retailers are obliged to offer a 'default' level of service and tariff to any customer, anywhere in Scotland. We set the maximum price caps that apply to default tariffs at our Strategic Review of Charges 2006-10. Our review also ensured that households are not landed with any additional costs as a result of the new competition framework.

Looking forward, we have required Scottish Water to provide detailed information about its costs and activities across its whole value chain. This information will be available in October. We expect that this may reveal scope for further efficiency and, consequently, better value for money for customers.

Scottish Water's performance

It is our role to monitor Scottish Water's performance and to ensure that customers get the benefits they have paid for. We published our last assessments of Scottish Water's performance for 2006-07 in the autumn of 2007. In most areas Scottish Water is performing very well. In the period 2002-07, Scottish Water reduced its operating costs in real terms by £170 million per year. It improved the efficiency of its capital investment delivery during the first regulatory control period (2002-06) by 22% or £494 million. As a result, the average household now has a bill that is some £90 a year lower than it would otherwise have been.

The level of customer service provided by Scottish Water has also improved markedly, and Scottish Water is well on track to achieve the levels of service target we set for 2010.

But there is no room for complacency. Scottish Water is currently charged with delivering the largest investment programme in Great Britain (on a per connected property basis). Only Thames Water has a larger investment programme in absolute terms and it serves about 1.5 times as many water customers and more than twice as many sewerage customers. It is a matter of record that Scottish Water made a slow start to delivering its programme. Although our most recent updates from Scottish Water indicate that investment activity did increase towards the end of the 2007-08 financial year, we remain concerned that delivering the remainder of this programme efficiently by the end of March 2010 will be a major challenge. We are monitoring progress very carefully.

We are also concerned about Scottish Water's progress in meeting its leakage targets. Scottish Water has reduced its reported leakage from 1,104 Ml/day to 1,004 Ml/day. However, it still fell short of our target for 2006-07 by 44 Ml/day. There can be no question that the current level of leakage is too high, but Scottish Water is beginning to make progress. Again, we will hold Scottish Water to account for its performance in this area.

Prospects for prices

We expect the current benign outlook for water and sewerage charges to continue beyond 2010 if Scottish Water continues to meet its targets.

Our work on the Strategic Review of Charges for 2010-14 began in the autumn of 2006 – only about six months after the price caps for the current regulatory period had come into force. In the past 12 months we have undertaken a detailed consultation on the key issues of the review, and published our conclusions. We will publish our final determinations on 30 November 2009.

The strengthened governance arrangements, the Government's commitment not to take a dividend and the continuing improved performance of Scottish Water are all contributory factors to this positive outlook for customers' charges.

Looking forward

Scottish Water has come a long way since it was established in 2002. It has reduced its operating costs significantly and, at the same time, improved the level of service it provides to customers. It has also improved its compliance with more demanding environmental and public health standards, and in the last 18 months has responded much more effectively to the needs of developers. There is much here to commend the public sector model for Scotland's water industry.

Six years ago the industry in Scotland faced challenges on every front. We have made a lot of progress – but there is still further to go.

However, further challenges remain for Scottish Water. In particular, it faces a significant challenge to deliver the remainder of the investment required, and financed, by customers in this regulatory control period. It also needs to reduce the level of leakage.

I would like to take this opportunity to thank the staff who do such an excellent job in supporting me and the other Commission members. They are only a small team but they have made a very significant contribution to bringing benefits for all water and sewerage customers in Scotland.

I was delighted that Sir Ian Byatt accepted his re-appointment as Chairman of the Commission for a further three years and that Mike Brooker and John Banyard have also accepted re-appointments for three-year terms. They, together with Charles Coulthard and David Simpson who continue as Commission members, have provided extremely valuable counsel and served the Scottish water industry well. I look forward to continuing to work with them.

Alan D A Sutherland
Chief Executive
25 June 2008

Areas of activity 2007–08

Making sure that customers get value for money: regulating prices

Customer bills should represent the best possible value for money.

We conduct price reviews to ensure that they do.

This year:

- Increases in average household bills were restricted to 0.5% less than the rate of inflation.
- Average Scottish household bills were £15 lower than in England and Wales. We forecast that they will be £20 lower next year.
- We predicted that prices beyond 2010 are likely to remain stable.

Why is regulating prices important for customers?

Price regulation is bringing real benefits for customers of the Scottish water industry. Every four years we carry out a strategic review of Scottish Water's charges. At the close of the 2002-06 strategic review period, average household bills were £90 cheaper than they would otherwise have been. During 2006-10, bills will rise by less than the rate of inflation. We expect that prices beyond 2010 will also remain stable.

The strategic review process is designed to ensure that customers get value for money. Scottish Ministers first set objectives for Scottish Water to achieve over the four-year regulatory control period. These objectives relate to the environment, drinking water quality and customer service, and may consider important issues such as sustainable development. Ministers also specify the principles that should underpin charges to customers.

We ensure that Scottish Water is fully resourced to deliver the environmental, drinking water quality and customer service improvements specified by Scottish Ministers.

Our role is to determine the level of resources that Scottish Water should require to deliver ministerial objectives at the lowest reasonable overall cost. We translate this resourcing requirement into caps on the prices that household customers pay. We also calculate caps on the wholesale charges and default tariffs that apply in the competitive market for non-household customers.

To ensure that customers pay no more than necessary we:

- work with the Scottish Environment Protection Agency (SEPA), the Drinking Water Quality Regulator (DWQR) and our engineering advisors to assess whether Scottish Water's business plans are appropriate to meet ministerial objectives; and
- carry out analysis to establish the scope for Scottish Water to deliver the same outputs for less money by becoming more efficient.

Our assessment of the scope for efficiency is important because it has a direct impact on the level of bills. We benchmark Scottish Water with the English and Welsh water and sewerage companies to gauge the scope for improvement.

We also work with the Scottish Government to establish a governance framework for the industry that creates appropriate incentives for Scottish Water and its management to improve its performance.

Effective governance and incentives

Our 2005 strategic review put in place six measures to strengthen the governance of Scottish Water and create appropriate organisational incentives. These measures help to protect customers from risk and ensure that they are not expected to pay for any underachievement by Scottish Water during the 2006-10 regulatory period.

Output Monitoring Group	We secured the agreement of Scottish Ministers to establish and chair an Output Monitoring Group to monitor progress in delivering ministerial objectives. This significantly increases the transparency of decision-making.
Hard budget constraint	Ministers agreed to a hard budget constraint which means that, should Scottish Water spend the financial resources available without achieving the required outputs, Scottish Ministers (and not customers) are liable to meet the costs of remedying this.
Interim determinations and dedicated public expenditure	We recognised that management cannot be expected to absorb all risks. Where events, such as a new quality obligation, are outside the control of management, we are ready to change price limits within the four-year period, or formally to recognise that such events will be fully dealt with at the next strategic review. In order to maintain the limits on borrowing, we agreed with Scottish Ministers a £50 million credit line to allow for events outside management control that may not be large enough to qualify for an interim determination. This £50 million is dedicated public expenditure, which can only be accessed with the prior agreement of both Ministers and us.

Gilts buffer	We agreed with Scottish Ministers that provision should be made for a fund – a buffer – against risks and uncertainties. The buffer is to be invested in index-linked, gilt edged securities, in which excess cash arising from outperformance on capital or operating costs can be held.
Rolling incentives	We stated our intention to introduce rolling incentives similar to those introduced by Ofwat in its 1999 price review. These rolling incentives allow the benefit of any outperformance that an organisation achieves to be retained for four years. The benefit is then passed to customers.
Managerial incentives	We were pleased that Scottish Ministers recognised the importance of aligning managerial incentives with the organisational incentives established through regulation. Ministers recognised that bonuses should be linked to the outputs financed in the strategic review and only be paid if Scottish Water outperformed its targets.

Progress this year

We will publish our review of Scottish Water's charges for 2010-14 on 30 November 2009. This year we consulted extensively with stakeholders about the methodology we should use to conduct the review. We also issued guidance to Scottish Water about the content of its first draft business plan.

Consulting on our methodology

Our consultation with stakeholders during the summer considered the following key issues:

- Should we protect customers from unnecessary risks? If so, how?
- How can Scottish Water be encouraged to improve levels of service?
- By how much should Scottish Water be expected to improve its efficiency?
- Will the size of Scottish Water's investment programme affect the efficiency with which it can be delivered?

Our approach to each of these issues will impact on the prices customers pay in the future. It was therefore essential for us to understand stakeholders' views and priorities in relation to them. We would like to thank all those who responded. We issued our conclusions in December 2007.

Researching important issues

Our consultation raised a number of issues about the size of the investment programme for the 2010-14 period. Scottish Water's slow start to the current investment programme (ie 2006-10) prompted concern that if the next programme is too large, this could affect Scottish Water's ability to deliver it efficiently. In our view, this would not be in the interests of customers.

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. The report concluded that a mid-sized programme, averaging approximately £400-£450 million per year, is to be preferred over a larger programme. This is about the same as Scottish Water's investment programme to deliver the ministerial objectives for 2006-10. The investment programme that Scottish Water is currently delivering is some 10-15% larger as it includes a significant overhang from the 2002-06 regulatory control period.

It is in the interests of customers that Scottish Water's investment programme is manageable and can be delivered efficiently.

Responding to the principles of charging consultation

Towards the end of 2007, the Scottish Government consulted on the principles of charging and objectives that would underpin the price review for 2010-14. In our response to the consultation we supported the propositions that:

- inefficiencies by Scottish Water which led to any financial underperformance would have to be met by direct financial support from the Government; and
- the investment programme for 2010-14 should be set "at a level that is efficiently manageable by a company of Scottish Water's size".

We also welcomed the statement that "Ministers remain committed to incentive based regulation and development over time of a reserve in the form of gilts". We believe these issues are fundamental in ensuring that customers get the best possible outcome from the next price review.

Guiding Scottish Water on its business plan

In December 2007 we issued guidance to Scottish Water on its first draft business plan. Scottish Water uses its business plan to set out how it will achieve ministerial objectives over the regulatory control period, and the resources it will need to do so. Scottish Water has a statutory duty to contribute to sustainable development. We will look for evidence that Scottish Water is considering sustainable solutions and long-term planning issues in its business plan. Scottish Water submitted its business plan on 30 May 2008.

Building an understanding of our work

It is important that all stakeholders have the opportunity to express their views on the price review. Our methodology consultation necessarily considered some complicated issues. We tried to ensure that our formal written consultations were as accessible as possible.

We also held eight stakeholder information workshops to support our consultation process – four before we published our consultation and four afterwards. Each workshop focussed on a specific area of the price review including financing and governance, levels of service, operating costs, and capital investment. We would like to thank all those who attended to voice their views and ask us questions. We are also grateful to Waterwatch Scotland, which hosted one of the events.

A summary of each workshop and the issues raised can be found on our newly redeveloped website www.watercommission.co.uk. The website also includes a section dedicated to the price review.

The regulatory framework that is applied to Scottish Water attracted significant interest this year. We welcomed visitors from the Republic of Korea and Malaysia who came to find out more about the Scottish regulatory model. We also presented at a number of events including the European Policy Forum, Regulatory Policy Institute and Holyrood magazine's conference 'Turning the tide – the future of Scotland's Water'.

We co-sponsored research into how the framework could be usefully applied elsewhere in the Scottish public sector. Jointly sponsored by ourselves, Shepherd and Wedderburn LLP, the Office of Fair Trading, and Audit Scotland, the David Hume Institute and Jo Armstrong considered the key influences on Scottish Water's success to date, and whether they could be applied to social housing, care services and waste management.

Looking forward: next steps

We independently determine charge levels based on the lowest overall reasonable cost of delivering ministerial objectives. When we issued our last determination of charges in 2005, we predicted, based on information available at the time, that charges during 2010-14 could also remain stable. Almost three years on, we still see no reason why prices cannot remain stable beyond 2010.

Can prices remain stable beyond 2010? At present we think they can.

Shortly after the close of the 2007-08 financial year, the Minister for Transport, Infrastructure and Climate Change, Stewart Stevenson MSP, issued the Scottish Ministers' draft principles of charging statement for 2010-14. We are pleased that the Ministers proposed that Scottish Water's investment programme should be no higher than £500 million per year. We also noted the Ministers' policy objective that average charge levels should be kept constant in real terms during the 2010-14 period. Ministers are scheduled to issue further guidance on objectives and principles of charging in September 2008.

The Ministers' guidance will help to inform Scottish Water's second draft business plan, due to be submitted in March 2009. We will use the plan to help inform our final calculation of price caps.

The table below sets out the timeline for the remainder of the review.

Event or activity	Date
Scottish Water submits its first draft business plan	30 May 2008
We respond to Scottish Water's first draft business plan	31 July 2008
Ministers issue guidance on the principles of charging and objectives	30 September 2008
We issue guidance to Scottish Water on its second draft business plan	15 October 2008
MSP update	10 December 2008
Stakeholder information workshop 9 to discuss governance and incentives	15 January 2009
Stakeholder information workshop 10 to discuss how price limits are calculated	5 February 2009
Stakeholder information workshop 11 to discuss customer service	26 February 2009
Stakeholder information workshop 12 to discuss investment and quality	12 March 2009
Scottish Water submits its second draft business plan	13 March 2009
Stakeholder information workshop 13 to discuss supply and demand/water resources	9 April 2009
Stakeholder information workshop 14 to discuss capital maintenance	30 April 2009
Stakeholder information workshop 15 to discuss operating cost efficiency	21 May 2009
Stakeholder information workshop 16 to discuss capital expenditure efficiency	11 June 2009
We publish our draft determination of price limits 2010-14	30 June 2009
Stakeholder information workshop 17 to discuss our draft determination	30 June 2009
MSP update	30 June 2009
Close of period for representations on the draft determination	23 September 2009
Ministers issue Directions for 2010-14	23 September 2009
We publish our final determination of price limits for 2010-14	30 November 2009
Stakeholder information workshop 18 to discuss our final determination	30 November 2009
MSP update	30 November 2009

Has Scottish Water delivered for its customers? Monitoring progress

We challenge Scottish Water to become more efficient and provide a better service. We scrutinise its performance to make sure that it has delivered for customers.

This year we reported that:

- savings of £1 billion have been made since 2001, helping to keep prices stable;
- levels of service (as measured by an overall performance assessment) improved by 40% in 2006-07; but
- more progress needed to be made in delivering investment to the benefit of customers and tackling leakage.

Why is monitoring Scottish Water's progress important for customers?

Between 2006 and 2010, customers are financing more than £2 billion of investment through their water bills. This investment is required to meet a series of objectives specified by Ministers. These objectives include providing cleaner beaches and rivers, improving drinking water quality and delivering a better service to customers. It is important that customers receive the improvements they have paid for.

We monitor Scottish Water's progress in three ways:

- We assess how efficiently Scottish Water is spending the money it receives from customers.
- We measure levels of service to customers using an overall assessment of performance (OPA).
- We monitor whether customers are receiving the benefits that Scottish Water's investment is required to deliver.

Scottish Water is becoming more efficient, helping to keep bills lower than they would otherwise have been.

Progress this year

Greater efficiency, lower bills

Scottish Water's day-to-day running costs account for around a quarter of the money it spends, and customers pay these costs directly through their bills. We therefore monitor Scottish Water's progress in this area very carefully.

This year we were pleased to report that Scottish Water had reduced its operating costs for five years in a row. These costs are some 40% lower than they were in 2001. As a result customers are saving around £3 million a week. Scottish Water's achievement in reducing its operating costs so quickly is unprecedented in the UK water industry.

Better customer service

Efficiency is not about cutting corners. At the same time as reducing its costs, Scottish Water has improved service to customers.

In 2005, we set Scottish Water annual targets to improve its customer service using Ofwat's OPA. Each year we review Scottish Water's customer service performance against these targets. During 2006-07 Scottish Water beat its target, improving service to customers (based on the OPA) by 40%.

For customers, this meant:

- fewer experienced problems of inadequate pressure;
- fewer experienced lengthy unplanned interruptions to supply;
- better drinking water quality;
- leakage was reduced (although by less than the target we had set);
- fewer experienced flooding from their property's sewer;
- calls were answered more promptly; and
- queries regarding bills were dealt with more quickly.

However, unfortunately, fewer complaints were dealt with within the required time of 10 working days.

We are encouraged that Scottish Water is in a strong position to achieve or beat our OPA target for 2010. Customers are now getting a much better service because Scottish Water's managers have made a determined effort to achieve our target. In this regard we believe that customers are benefitting from the decision of Scottish Water's board to make the level of service to customers an important factor in the award of bonuses to management and staff.

Slow start to investment

In the autumn we were disappointed to report that during 2006-07 Scottish Water had made a slow start in delivering the capital investment programme to meet the objectives set by the Scottish Government.

Scottish Water's investment programme is the largest being undertaken by any water company in Great Britain on a per connected property basis. We were concerned that Scottish Water's lack of progress in the early stages of the programme may mean that benefits paid for by customers are delayed beyond 2010. We were also concerned because some projects that were due to be delivered by April 2006 (as part of the last regulatory control period) may not now be completed until 2010-11.

We met Scottish Water's board in October 2007 to discuss progress with the investment programme. Scottish Water acknowledged that a slow start had been made, but stated that it was taking a number of steps to improve the situation. We asked Scottish Water to increase the frequency of information on progress it provides us from quarterly to monthly updates. This allows us to scrutinize Scottish Water's progress more closely during this critical time.

Our most recent progress updates from Scottish Water suggest that investment expenditure increased markedly towards the end of 2007-08. This is an encouraging sign, but it remains challenging for Scottish Water to deliver all of the outputs required to meet ministerial objectives on time and on budget. In particular, Scottish Water must start transforming increased investment expenditure into outputs that are 'signed off' by the quality regulators.

Leakage needs to be tackled

Leakage is an issue that needs to be addressed by Scottish Water. In 2006 we set Scottish Water pragmatic targets to make annual reductions in its leakage. We required Scottish Water to reduce its leakage by 16% by 2006-07. We were disappointed that Scottish Water only achieved a 12% reduction, particularly as part of this reduction resulted from a restatement of estimated water consumption by unmetered non-household customers.

It is concerning that Scottish Water missed this target as a significant allowance for leakage reduction is being paid for by customers through their bills. It is also concerning given that significant importance has been attached to the role leakage reduction can play in contributing to environmental improvement and reducing carbon emissions.

Building an understanding of our work

We aim to make our work in monitoring Scottish Water's performance as accessible as possible, so that stakeholders can scrutinise progress. This public scrutiny is important as it places additional pressure on Scottish Water to improve.

We work closely with Scottish Water's other regulators to monitor progress with its investment programme. The Scottish Government-chaired Output Monitoring Group (OMG) is made up of representatives from the DWQR, SEPA, Scottish Water, Waterwatch Scotland, and us. The group meets every three months to consider detailed reports on progress compiled by a working group (which we chair). The OMG focuses on ensuring that Scottish Water delivers all of the benefits promised to – and financed by – customers.

We produce three annual reports covering Scottish Water's customer service, costs and performance, and delivery of investment. Over the last two years we have taken into account stakeholder feedback that our reports could be simplified, and have produced more concise, customer-focused documents.

Looking forward: next steps

We will continue to monitor Scottish Water's customer service performance. It has made a good start, but there is still more to do to bring it into line with England and Wales. We will also continue to monitor progress with improving operating cost efficiency.

Scottish Water must take proactive steps to address leakage. In addition to reaching our pragmatic leakage targets, Scottish Water is also financed to devise a method of calculating its 'economic level of leakage' – the point at which the cost of reducing leakage is the same as the cost of water lost. Scottish Water is required to become 50% closer to this economic level of leakage by 2010, and to achieve it by 2014.

We have formed a Regulatory Leakage Group with Scottish Water. The group uses the engineering expertise of our regulatory Reporter. The group's role is to oversee the required improvements in leakage information and monitor progress with the development of an economic level of leakage. We expect significant progress to be made in the future.

Progress is not about how much money has been spent, rather whether this investment is delivering the intended outcomes.

We continue to monitor carefully Scottish Water's progress with its investment programme. The investment programme is designed to deliver significant environmental, drinking water quality and customer service improvements. It is important to reiterate that the planned investment programme is very large and almost without precedent. It is in the interests of customers that these benefits are delivered efficiently.

Scottish Water's recent increase in investment expenditure suggests that the pace of delivery is increasing. However, it should be emphasised that increased expenditure does not necessarily mean that customers are benefitting from investment. In particular, when projects are completed, it is important that DWQR and SEPA 'sign-off' the completed work as fit for purpose. We will continue to work closely with SEPA and DWQR to ensure that outputs have been delivered.

Facilitating greater value and choice through competition: a new era for business customers and public bodies

The introduction of competition allows business and public sector customers to choose a supplier that best meets their service and price requirements.

This year:

- business and public sector customers in Scotland became the first in the world to be able to choose their supplier;
- we awarded licences to four suppliers – Aquavitae, Business Stream, Osprey and Satec;
- we reported that Business Stream had reduced its costs by £10 million a year while Scottish Water had saved more than £1 million.

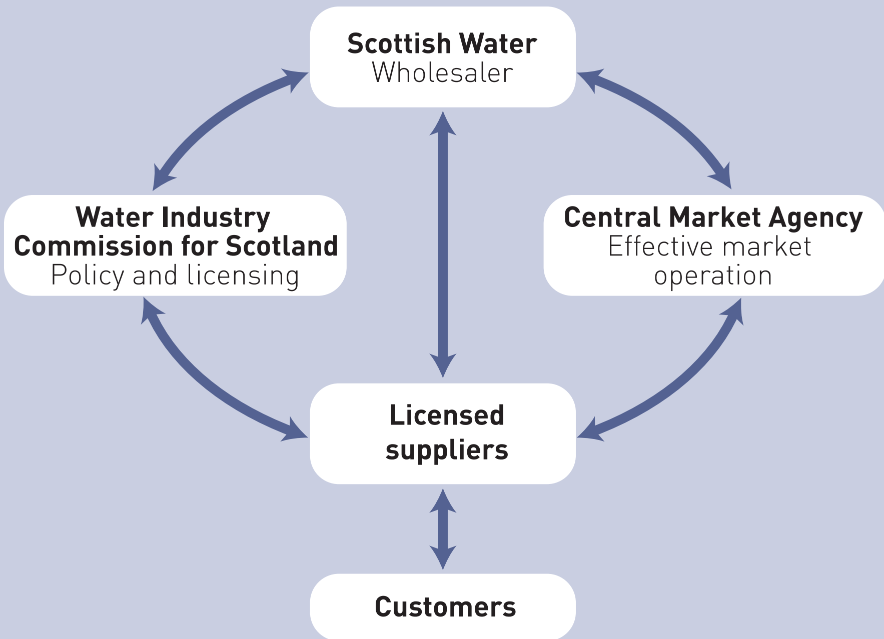
Why is competition important for customers?

On 1 April 2008 the competitive market for business customers and public bodies in Scotland opened. These customers became the first in the world to be able to choose their water and sewerage supplier. Competition should bring wider choice, lower prices, better service and more innovation. Household customers should also benefit as additional pressure is likely to be placed on Scottish Water to improve its efficiency.

Competition in the Scottish water industry was introduced by the Water Services etc. (Scotland) Act 2005. The Act required Scottish Water to establish a separate retail entity (now called Business Stream) to serve business customers and public bodies. New suppliers, who must be licensed by us, can compete with Business Stream for these customers. Scottish Water acts as the wholesaler in the market, operating Scotland's publicly owned water and sewerage network and treatment works.

The diagram below shows how the market works.

How the market works



Benefits for all customers

Separating out wholesale and retail activities has already allowed Scottish Water to identify improvements in service and costs that it can avoid – these savings will benefit both business and household customers. Over time, Business Stream and new suppliers are likely to exert further pressure on Scottish Water to improve its efficiency. A more efficient Scottish Water will benefit all customers.

Our analysis shows that there have already been significant benefits from requiring Scottish Water to split its retail arm, Business Stream, from its monopoly wholesale business. Business Stream has reduced its costs by £10 million a year, while Scottish Water has saved more than £1 million. The total savings made by Scottish Water and Business Stream are £4 million higher than the additional new costs that we allowed for in setting prices. With set up costs having been limited to £17.5 million, the payback period on the competitive market is likely to be around four years.

Benefits for business customers and public bodies

We expect new suppliers to compete to offer service and price packages that are right for individual business customers and public bodies – bringing an end to the 'one size fits all' approach to service. Suppliers may offer:

- lower bills;
- different methods of payment;
- different levels of response to problems;
- advice on water or waste water services; and
- many other potentially useful services.

The framework for competition in Scotland set out by the 2005 Act also allows more flexible and innovative deals. If a customer, supplier or indeed Scottish Water can identify a way to reduce Scottish Water's wholesale costs, a reduction can be made to the wholesale charge. A proportion of these savings will ultimately be passed on to end customers, including households.

This is an important incentive for customers, their suppliers and Scottish Water to seek out more innovative and cost-effective methods of service provision.

We believe that competition may also bring wider benefits. Increasing numbers of companies – not just the large bulk users of water services – are interested in reducing their consumption of water. This is not just a response to cost pressures but also a greater awareness of environmental issues. We expect that suppliers in the competitive market will respond to their customers' demands and develop more 'environmentally friendly' initiatives.

Measuring success

A number of Business Stream's customers have already made significant savings as a result of better water consumption information. Tesco estimates that it achieved savings of over £1 million more quickly in the past year because of the improved service it received.

There are a number of ways that the success of the market could be measured. In some industries, the number of customers who change their supplier is used as a measure of how well the market is functioning. Whilst this measure suggests that customers who switch suppliers are doing so in order to get a better deal, it does not take into account how customers who choose to remain with their supplier (perhaps because they have been offered a better deal to stay) are benefitting.

We will measure the success of the new market on how many customers are getting a better deal. If a customer stays with Business Stream and is getting a better service or a better price, we would regard that as a success of the competitive market.

Progress this year

Our focus this year was on preparing for the opening of the market on 1 April 2008. We worked towards the following objectives.

Customers should benefit from real choice

We want business customers to have good information about their choice of supplier and to be able to exercise that choice with ease. In the run up to market opening we conducted a PR campaign to raise awareness about the changing industry and the options available. We also established an independent Central Market Agency to facilitate the simple and effective transfer of the customer information of those who choose to change supplier.

No customer should be adversely affected by competition

To ensure that no business customer or public body is worse off as a result of the introduction of competition, we introduced a licence condition for new suppliers to offer customers a default tariff and level of service. This means that business customers and public bodies have the option of choosing the regulated tariff they would have received had Scottish Water remained the monopoly supplier.

Suppliers should be confident there is a level playing field

Business Stream is both the incumbent supplier in the market (inheriting all of Scottish Water's business customers) and part of the Scottish Water Group. We placed additional licence conditions on Business Stream to ensure that it operates at arm's length from Scottish Water and enjoys no competitive advantage.

It is important that suppliers can be confident that they are competing for customers on an equal footing. We have ensured that all suppliers sign up to the same codes, processes and charges schemes. During 2007-08 we published:

- a market code that sets out how the market will work;
- an operational code explaining what suppliers should expect from Scottish Water;
- a disconnections document setting out a standard process for disconnections;
- a template wholesale services agreement to aid new suppliers' negotiations with Scottish Water; and
- a wholesale charges scheme that applies to all licensed suppliers.

Scottish business customers and public bodies are the first in the world to be able to choose their supplier. On the first day of the new market they had four suppliers to choose from.

This year we also considered four licence applications from potential new suppliers: Aquavitae, Business Stream, Osprey and Satec. Shortly after the close of the financial year, we received licence applications from Ondeo. All five met the financial and technical competence requirements to be awarded licences.

Building an understanding of our work

It is important that potential licensees and business customers are aware of and understand the opportunities presented by the market. The PR campaign we undertook in the run up to 1 April included radio, TV and newspaper interviews, magazine articles, radio advertising, and the distribution of leaflets to more than 20,000 businesses and public bodies in Scotland.

We commissioned a new, bespoke website 'Scotland on Tap' which provides clear and simple information to customers about:

- the changes that have taken place in the industry;
- who is involved in those changes;
- the opportunities for customers;
- how to find out more.

We are particularly grateful to the Major Energy Users' Council which co-hosted competition seminars in Glasgow and London. These events attracted more than 150 guests.

We also gave suppliers an opportunity to comment on how the market framework develops. During 2007-08 we issued 10 consultations on issues such as the process for disconnections and discounts on the wholesale charge. We would like to thank all those who responded.

We worked with customer representative groups to help get the message about competition out to their members. Our Chairman, Sir Ian Byatt, visited local authorities and business organisations over the course of the year to keep them updated about the introduction of competition and our work.

During the year he visited (in chronological order):

- Dumfries and Galloway Council;
- Scotch Whisky Association;
- Stirling Council;
- Communities Scotland;
- Scottish Chambers of Commerce;
- Glasgow City Council;
- Falkirk Council;
- Scottish Enterprise;
- CBI Scotland; and
- National Farmers' Union.

Our annual Comiston lecture also focused on competition. The Comiston lecture was established in 2002 by the former Water Industry Commissioner to bring together the wider water industry and regulatory stakeholders. We are grateful to Philip Collins, Chairman of the Office of Fair Trading, who gave a lecture in Edinburgh entitled 'Regulation – the second best option?' in March to around 100 invited guests.

Looking forward: next steps

Over the coming year our work will focus on strengthening the newly opened competitive market for business customers and public bodies. This will include:

- examining the scope to refine the allocation of activities between Scottish Water as the wholesaler and retail suppliers;
- further encouraging licensed suppliers to be proactive in the market – by both communicating the opportunities for customers, and challenging Scottish Water to be more efficient; and
- encouraging customers, licensed suppliers and Scottish Water to explore the potential for departures from the wholesale charge.

Customers are already benefitting from the competitive market. We will explore ways to encourage the market to deliver even more.

In December 2007 we asked Scottish Water to provide detailed information about its costs across the whole range of activities it performs, including water resources, treatment and networks. We expect this information to reveal the scope for further efficiency and, consequently, better value for money for customers. It may also identify if there is scope for further extending competition into wholesale water and sewerage services. This information will be available in October 2008.

In the autumn of 2008 we will publish our first review of the market and how it is delivering benefits to customers.

Financial review

Financial information provided in this report is unaudited and is subject to external audit by Audit Scotland.

UNAUDITED SUMMARY INCOME AND EXPENDITURE ACCOUNT FOR THE YEAR ENDED 31 MARCH 2008

Income	**Notes**	**£**
Scottish Water statutory contribution		3,553,944
Other income		56,340
Total income		**3,610,284**
Expenditure		
Staff remuneration	1	1,952,865
Staff travel and subsistence		65,502
Accommodation		144,019
General operating costs		277,069
Consultancy projects		1,243,347
Recruitment		188,374
IT support		239,369
Licensing		1,044,840
Non-cash costs (eg depreciation)		112,509
Finance charges		6,107
Meeting costs		31,527
Total expenditure		**5,305,528**
Net deficit		**(1,695,244)**

In line with changes to the Financial Reporting Manual in 2006-07 grant-in-aid received from the Scottish Government has now been shown as a financing flow and no longer as income. Grant income of £1,914,218 in 2007-08 has instead been credited to the General Reserve.

This summary account also includes unaudited income and expenditure from Waterwatch Scotland.

UNAUDITED BALANCE SHEET
AS AT 31 MARCH 2008

	Notes	31 March 2008 £
Fixed assets		
Tangible assets	2	452,347
Current assets		
Debtors & prepayments		63,730
Cash at bank and in hand		313,796
		377,526
Current liabilities		
Creditors: amounts falling due within one year	3	(554,483)
Net current liabilities		(176,957)
Net assets excluding pension assets and liabilities		275,390
Pension assets		1,206,000
Pension liabilities		(1,089,000)
Net assets including pension assets and liabilities		392,390
Capital and reserves		
General reserve	4	392,390

NOTES TO THE UNAUDITED FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2008

1. Staff

The aggregate cost of remuneration comprises:

	Year ended 31 March 2008 £
Employees' remuneration	1,835,536
Remuneration paid on behalf of the Water Customer Consultation Panel deducted from levy payments made to them	(174,921)
	1,660,615
Employer's National Insurance contributions	133,250
Current service costs and amounts payable to defined contribution scheme	159,000
Amounts included within operating profit	1,952,865

The average number of staff employed in the period by the organisation was 50 (including the Chief Executive). These were employed in the following areas:

Water Industry Commission for Scotland	Year ended 31 March 2008
Directors, including Chief Executive	4
Corporate Affairs	10
Analysis	9

Waterwatch Scotland	Year ended 31 March 2008
Convenor and Head of Corporate Services	2
Complaints Handling	3
Research	1
Administration	2
Panel members	19

NOTES TO THE UNAUDITED FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2008

2. Tangible fixed assets

	Assets under construction £	Equipment £	Furniture & fittings £	Total £
Cost				
At 1 April 2007	134,008	212,042	230,789	576,839
Additions	4,113	121,546	112,454	238,113
Disposals	-	(77,553)	(67,076)	(144,629)
At 31 March 2008	138,121	256,035	276,167	670,323
Depreciation				
At 1 April 2007		147,400	101,896	249,296
Charge for the year		58,635	27,626	86,261
Eliminated on disposals		(73,487)	(44,094)	(117,581)
At 31 March 2008	-	132,548	85,428	217,976
Net book value at 31 March 2008	**138,121**	**123,487**	**190,739**	**452,347**

3. Creditors: amounts falling due within one year

	As at 31 March 2008 £
Trade creditors	375,824
Accruals and other creditors	178,659
	554,483

NOTES TO THE UNAUDITED FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 2008

4. Capital and reserves

	General reserve excluding pension reserve £	Pension reserve £	General reserve including pension reserve £
Balance as at 1 April 2007	48,416	(195,000)	(146,584)
Deficit for the year	(1,687,244)	(8,000)	(1,695,244)
Grant income from Scottish Government	1,914,218	-	1,914,218
Recognition of other recognised gains and losses	-	320,000	320,000
Balance as at 31 March 2008	275,390	117,000	392,390

Find out more

Business customers and public bodies can find out more about their choice of supplier and the new competitive market at:
www.scotlandontap.gov.uk

Copies of all our reports, including those cited in this Annual Report can be found on our website:
www.watercommission.co.uk

Associated documents include:

The Strategic Review of Charges 2006-10: the final determination (an executive summary)

Costs and performance report 2006-07

Customer service report 2006-07

Investment report 2006-07

Factors to be considered when determining the appropriate size of the next capital programme for Scottish Water. A report by LeCG

Both customers and the environment will benefit from competition in water services: the initial evidence from Scotland

June 2008

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