

## Costs and performance 2007-08



### Overview

This report examines Scottish Water's costs and performance in 2007-08.

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## INTRODUCTION

### Context

It is our role to monitor Scottish Water's performance and to ensure that customers get the benefits they have paid for. Ministers set objectives to improve water quality, environmental performance and customer service. We set prices that provide Scottish Water with sufficient resources to meet these objectives provided it meets our expectations of improved efficiency. We measure Scottish Water's progress in delivering the outputs and publish an assessment of its performance each year<sup>1</sup>.

The objectives are for a four-year regulatory control period. Definitive analysis of whether Scottish Water has outperformed or underperformed in its capital expenditure programme (that is, spending to maintain and improve its assets) cannot therefore be completed until the end of the regulatory control period. We will report on Scottish Water's expenditure on capital investment at the end of the 2006-10 regulatory control period.

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 scrutinize Scottish Water's performance in this area very closely. In this report we look back at the progress Scottish Water made in lowering its running costs during the reporting year 2007-08.

### Associated documents

- 'Costs and performance report 2006-07', Water Industry Commission for Scotland, November 2007.
- 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.
- 'Customer service report 2007-08', Water Industry Commission for Scotland, October 2008.
- 'Investment report 2007-08', Water Industry Commission for Scotland, October 2008.

<sup>1</sup> See 'Investment report 2007-08', published in October 2008.

# KEY MESSAGES

## KEY MESSAGES

We are pleased to report that Scottish Water continues to deliver services for substantially less operating cost than when it was formed (from the three former water authorities) in 2002.

Furthermore, Scottish Water is demonstrating that these lower operating costs are sustainable, which is excellent news for customers. As a result, customers' bills remain stable, and compare well with those in England and Wales.

The clear incentive framework for Scottish Water that we put in place at the last Strategic Review of Charges (published in November 2005) served customers well in both 2006-07 and in 2007-08. Scottish Water's progress was ahead of expectations, both on costs and on service to customers<sup>2</sup>.

Looking forward, the challenge is to maintain incentives so that Scottish Water keeps costs down whilst improving services further.

<sup>2</sup> See our 'Customer service report 2007-08', published in October 2008.

## PERFORMANCE ASSESSMENT

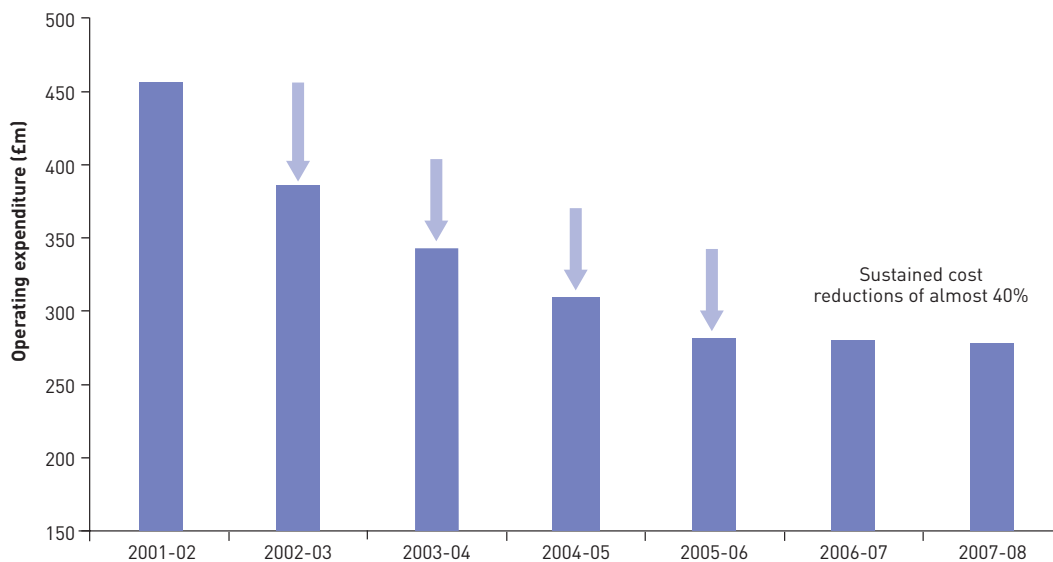
### Progress on operating costs

Since Scottish Water was formed in 2002 it has made good progress in reducing its running costs, with total cumulative savings of more than £800 million.

**At the same time as reducing costs, Scottish Water has improved its customer service significantly.<sup>3</sup>**

Figure 1 shows Scottish Water’s year-on-year progress in reducing its operating costs. In 2007-08 its running costs were around £180 million<sup>4</sup> lower than in 2002.

**Figure 1: Scottish Water’s progress on operating costs**



Since 2002, there has been an overall reduction in running costs of almost 40%. Although the pace of the reduction in these costs flattened out in recent years, Scottish Water continues to exert good control of its costs across the business.

In 2007-08 operating costs rose by slightly less than inflation. Cost pressures that Scottish Water faced included higher energy prices, more extensive water and waste water treatment processes, higher local authority rates, higher fees paid to the Scottish Environment Protection Agency and increased leakage detection and repair costs. We believe that Scottish Water has done well to contain these costs over this period, while providing better customer service.

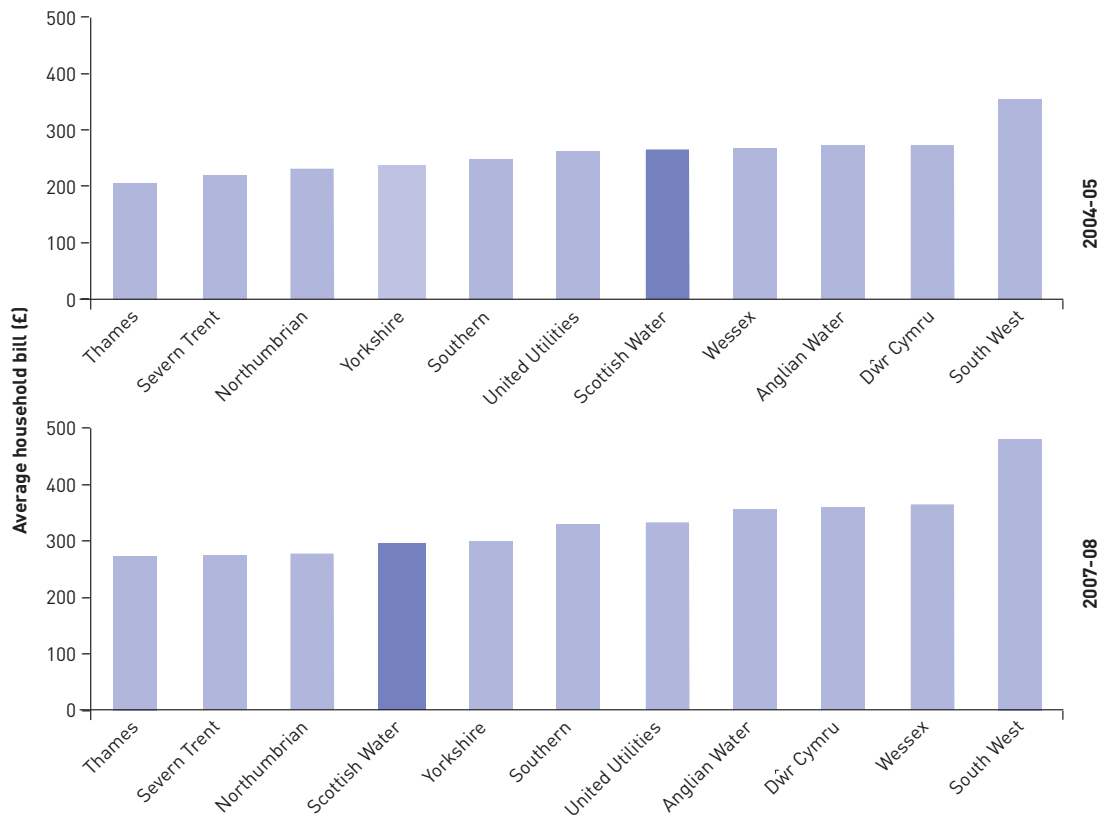
<sup>3</sup> We use the OPA (overall performance assessment), a points-based system to measure levels of service. Our 'Customer service report 2007-08' (October 2008) assessed Scottish Water's OPA as having increased to 248 from 133 in 2002.

<sup>4</sup> All costs and savings figures in this report are expressed in 2007-08 prices.

### Impact on customers' bills

Customers are seeing the benefits of Scottish Water's performance in reducing its costs through lower bills, which now compare well with those for customers in England and Wales. Whereas in 2004 average household bills for Scottish Water's customers were amongst the middle of the range of bills south of the border, they are now amongst the lower end. This is shown in Figure 2.

**Figure 2: Average household bills in 2004-05 and 2007-08<sup>5</sup>**



<sup>5</sup> These numbers are shown in outturn prices.

## A CLEAR INCENTIVE AND GOVERNANCE FRAMEWORK

At the last Strategic Review of Charges, we put in place a clear framework to strengthen the governance of Scottish Water and create appropriate organisational incentives.

These involved:

- proper limits on Scottish Water’s costs – if managers fail to meet expectations, costs will be met from public expenditure, not from customers;
- a temporary loan facility (£50 million until 2010) to cover unexpected costs such as emergencies or changes in legal obligations, but not the costs of management failure;
- a growing savings account (a ‘financial reserve’ and potentially ‘gilts buffer’), financed by outperformance of our expectations;
- transfer of savings to customers after four years, keeping bills down;
- bonuses to Scottish Water’s management that can only be paid when our expectations are beaten; and
- formal scrutiny every three months of Scottish Water’s delivery of the investment benefits required by Scottish Ministers.

The framework worked well in 2007–08. We set our expectations for improved efficiency in each year of the current regulatory control period, which runs from 2006 to 2010. We are pleased to report that in 2007–08 Scottish Water beat our expectations in operating costs by 5%. If this continues, customers should gain from lower prices in the next period of price controls, ie from 2010 to 2014.

### Maintaining the framework – the financial reserve

Maintaining the incentive and governance framework is essential to securing continued benefits for customers. The financial reserve is especially important, since it should allow Scottish Water flexibility to manage its business effectively, and to benefit from outperforming regulatory expectations. If Scottish Water performs better than we expected on its costs from year to year, it builds up a reserve of cash. The purpose of this reserve is to cover unexpected costs and cost overruns in other areas of the business.

In July 2008, Ministers published governance directions<sup>6</sup> that could reduce Scottish Water’s flexibility to manage its finances. The directions specify that Scottish Water may not withdraw funds from the financial reserve without the prior approval of Scottish Ministers. They further specify that Scottish Water must make withdrawals from the financial reserve if Scottish Ministers direct it to do so.

<sup>6</sup> The Scottish Water Governance Directions 2008, issued under the Water Industry (Scotland) Act 2002.

It is important that Scottish Water can manage its business flexibly over a full regulatory control period. There can be no guarantee of the extent to which a regulatory contract has been outperformed until the regulatory control period has ended. This is because Scottish Water has the full period to deliver ministerial objectives through its capital expenditure programme. We would not regard costs reduced by more than we expected as outperformance if some objectives had been missed as a consequence.

### **Maintaining the framework – the gilts buffer**

If Scottish Water sustains its outperformance on costs to the end of the regulatory period, we have agreed with Ministers that any resulting reserve can be invested in index-linked, gilt-edged securities.

This buffer is an important mechanism to protect customers against risks and uncertainties. It is accessible to Scottish Water only with the agreement of Scottish Ministers. In order to maintain proper limits on Scottish Water's costs and to incentivise the business it is essential that outperformance is assessed rigorously. We intend to publish our assessment.

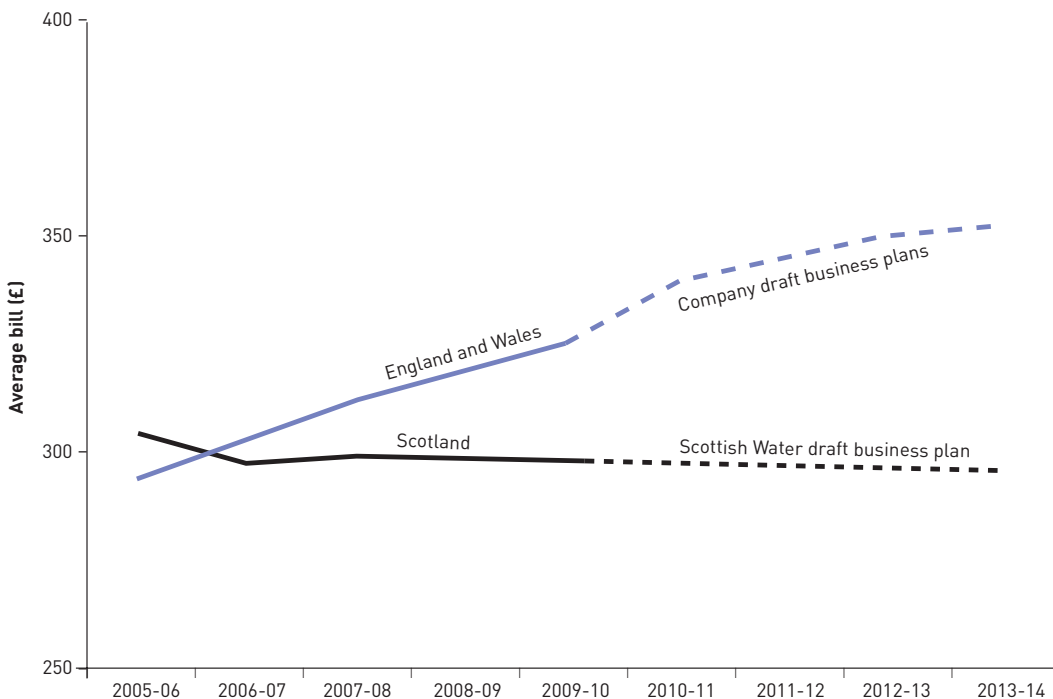
## LOOKING FORWARD

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. Furthermore, performance to date bodes well for the level of prices that customers will have to pay in the future.

**In 2008-09 average bills for Scottish households are some £20 lower than the average in England and Wales. We expect they will be £28 lower in 2009-10.**

Figure 3 shows the likely average bills up to 2009-10. It also provides projections of average bills up to 2014. The projected numbers are estimates based on business plan forecasts by the companies in England and Wales and by Scottish Water using the best information currently available. As such, the forecasts for the companies in England and Wales are subject to revision downwards by Ofwat, the regulator south of the border. The forecasts for Scottish Water may also change when we set price limits at the next Strategic Review of Charges in 2009. However, the forecasts do provide an indication of the relatively positive outlook for bills in Scotland.

**Figure 3: Actual and forecast average bills in Scotland, and in England and Wales<sup>7</sup>**



<sup>7</sup> These numbers are expressed in 2007-08 prices.





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