



Performance Report 2010

Overview

This report examines Scottish Water's progress in improving customer service, becoming more efficient, controlling costs and delivering investment outputs.

INTRODUCTION

We promote water and sewerage customers' interests by making sure that they receive both high-quality service and value for money.

Every five years we set prices that allow Scottish Water the resources it needs to deliver ministerial objectives for the water industry at the lowest reasonable overall cost. At the same time we set challenging targets for improvement and monitor Scottish Water's performance in meeting these.

At the start of each price setting period Scottish Water signs up to a 'regulatory contract'. The contract is transparent, achievable and subject to rigorous monitoring, with managerial incentives closely tied to performance against the contract.

As part of our monitoring we publish annual information on performance. The reporting year 2009-10 marks the final year of the regulatory control period 2006-10 so we are now able to report on performance over the whole four-year period. We published our final determination for the next regulatory control period, 2010-15, in November 2009.

In previous years we published our findings in three separate reports¹. This year we have combined the reports into a single document that provides an overview of performance since Scottish Water was established in 2002 (when the three former water authorities were merged)².

Associated documents

- The Strategic Review of Charges 2010-15: The final determination, November 2009.
- The Strategic Review of Charges 2006-10: The final determination, November 2005.
- Costs and performance report 2008-09, October 2009.
- Customer service report 2008-09, October 2009.
- Investment report 2008-09, November 2009.

¹ Reports on customer service, costs and performance, and investment for previous years are available on our website.

² Please note that all costs in this report are expressed in 2009-10 prices and that cost comparisons are expressed in real terms.

KEY MESSAGES

Overview

As the economic regulator of this public sector industry it is our job to make sure that customers receive the levels of service they expect for the lowest reasonable overall cost.

Over the past ten years we have developed a regulatory framework to ensure that this happens. In particular, we have adapted price cap regulation (or 'RPI-X regulation'³) – an approach used by all of the UK economic regulators – to the situation of Scottish Water, a public sector water company.

The framework comprises a number of different elements that combine to create the same impetus to excel that is experienced by companies subject to capital market pressures. Key to this has been our setting of challenging performance targets and cash limits, aligned with appropriate managerial incentives to outperform.

The performance targets are not aspirational, but are the minimum levels of acceptable performance. The cash limits are binding. Only if managers are able to outperform these requirements will they benefit from the bonus incentives that are in place.

It is this incentive-based framework that has produced the remarkable transformation of the water industry since Scottish Water was created in 2002. Customers have benefitted from:

- substantial improvements in the level of customer service⁴;
- substantial reductions in Scottish Water's operating costs, which are now around 35% lower;
- higher quality drinking water and a better water environment; and
- much lower leakage, which is now around 36% lower than the level of five years ago.

These improvements are all the more welcome in light of the fact that over the same period the water industry in England and Wales has seen its operating costs increase by 13%, while figures for customer service levels have remained stable.

Around £4.3 billion has been invested in Scotland in maintaining and improving the industry's assets, with over £2 billion of this committed to improving drinking water quality and environmental performance.

³ RPI-X regulation is a form of regulation that involves setting price caps that are measured relative to the retail price index (RPI). Setting maximum prices that Scottish Water can charge for its services for a period of years provides an incentive to improve its efficiency, as it must drive down costs in order to remain within cash limits.

⁴ As measured by the overall performance assessment score, which has more than doubled since 2002.

Ensuring value for money for customers

At our price reviews in 2001 and 2005 we challenged Scottish Water to provide value for money by requiring ministerial objectives for the industry to be delivered at £2.5 billion⁵ less than Scottish Water proposed in its Business Plans. Scottish Water accepted these challenges. As a result, average household bills are around £105 a year lower than they would otherwise have been.

Scottish Water not only made the improvements required of it but also outperformed in a number of areas. For example, it is providing better levels of service than were funded through bills and has beaten the leakage targets we set. This outperformance means that customers are getting more for their money; we estimate that the additional benefits now equate to around £12 per average household a year.

Scottish Water's performance in achieving and going beyond its targets clearly demonstrates the efficacy of the framework that is now in place. Furthermore, outperformance remains in the system to be used – at the next price review – for lower prices, better water and environmental quality, and better customer service – or some combination of all three.

Investing in Scotland's water industry

During the regulatory control period 2006-10 Scottish Water was tasked with delivering a very large investment programme; the largest in the UK per connected property. It made a slow start in the early years and we highlighted our concerns about this in previous performance reports. However, Scottish Water improved output delivery in the second half of the four-year period and made significant progress during the final year, 2009-10. As a result, the vast majority of the programme has now been delivered.

The outputs that remain to be delivered are being closely monitored; progress in completing these projects is currently ahead of schedule. We are pleased to note too that in some areas more outputs have been delivered for customers than were originally financed, including outperformance in areas such as drinking water quality, waste water compliance and tackling leakage.

Maintaining the regulatory challenge

Looking ahead, we consider that there are opportunities to develop our regulatory approach further, so that customers continue to receive the benefits of improved performance.

In this regard we propose to simplify price setting and to establish a new framework that allows more effective engagement between Scottish Water and customers. We are currently working closely with customer representatives and other stakeholders to develop our thinking in this area.

⁵ Our challenge was around £1 billion in 2001 and £1.5 billion in 2005.

INCENTIVISING PERFORMANCE

Our regulatory objectives, combined with a determination on the part of Scottish Water's management to rise to the challenges we set, have delivered significant benefits to customers and the environment.

We have set performance targets for Scottish Water that are minimum acceptable levels, not simply aspirational targets. We have also set binding cash limits. Only if managers are able to outperform these requirements will they benefit from the bonus incentives that are in place.

As this report shows, this overall approach has worked in customers' interests. For the regulatory control period 2006-10, Scottish Water was challenged to reduce its costs by £1.5 billion while still delivering all of the outputs for the water industry that were required by Ministers. The company managed to go further than this, providing efficiencies and additional benefits to customers to the value of around £175 million. We estimate that the additional benefits now equate to around £12 per average household a year.

The additional benefits comprise the following:

- cost savings – to the value of around £100 million;
- additional investment outputs – to the value of around £45 million; and
- better levels of service – to the value of around £30 million.

A tenet of the incentive-based approach is to reward good performance but to lock in these benefits for customers through a further raising of the bar. Our final determination for the regulatory control period 2010-15 placed an onus on Scottish Water to seek out further efficiencies and customer service improvements.

PERFORMANCE ASSESSMENT 2010

CUSTOMER SERVICE

How customer service is assessed

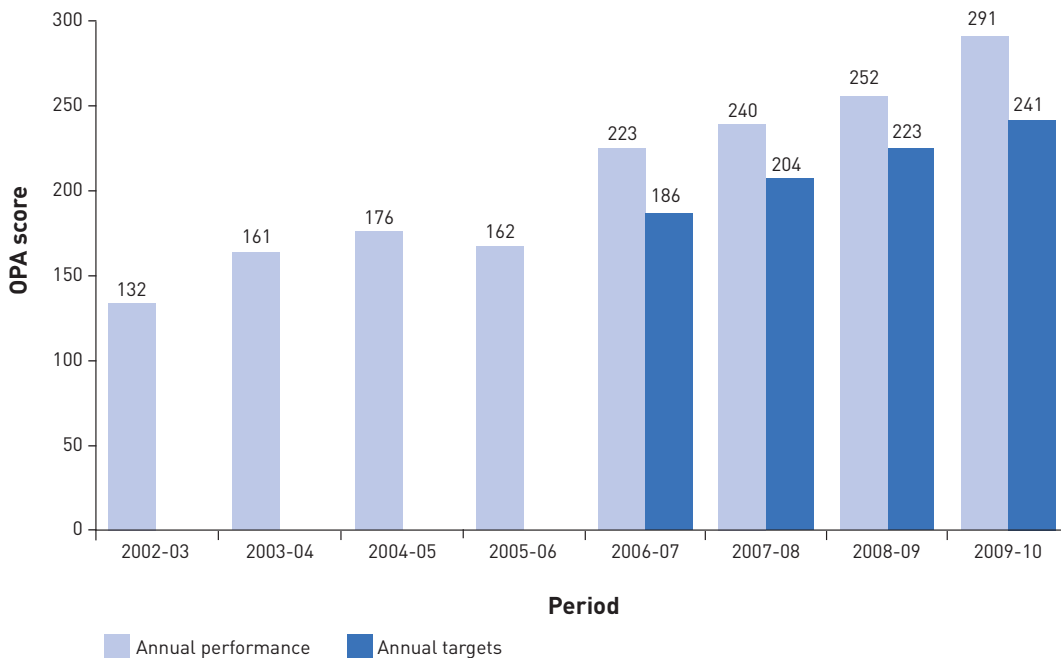
We first drew attention to the level of customer service in our 2001 price review, and in 2005 we set annual milestones for Scottish Water to improve in this area over the period to 2010.

We use a points-based system, the ‘overall performance assessment’ (OPA), which encompasses aspects of service that are most important to customers. To work out Scottish Water’s OPA we use customer service information that it provides each year. This is scrutinised for accuracy and reliability by an independent technical Reporter.

How Scottish Water performed

Scottish Water responded very well to its customer service targets and has significantly outperformed in this area. As Figure 1 shows, since it was formed in 2002 its OPA score has more than doubled, increasing from 132 in 2002-03 to 291 in 2009-10.

Figure 1: Scottish Water’s OPA targets and actual performance to date



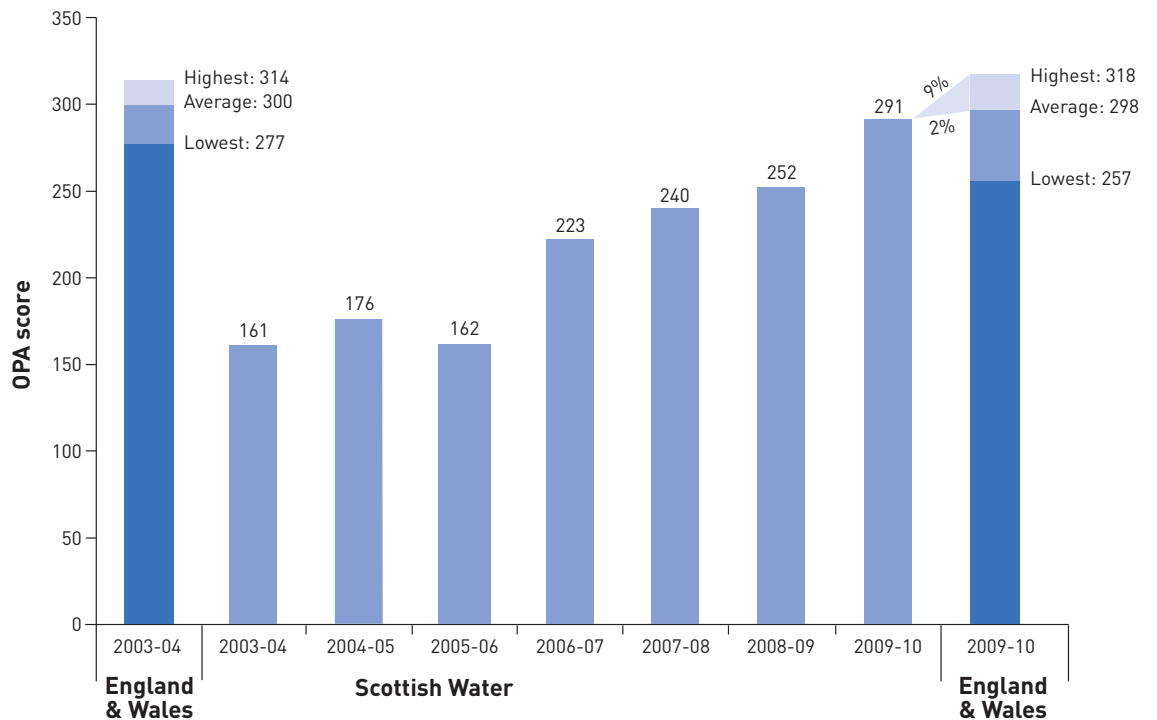
Scottish Water has consistently met and beaten its targets; the score in 2009-10 was 50 points higher than the target we set for that year.

We believe that customers are benefitting from the Scottish Government’s decision to make the improvement in the level of service provided to customers an important factor in the award of bonuses to management and staff.

Comparison with England and Wales

Figure 2 compares Scottish Water’s performance trend with that of the highest, average and lowest OPA scores achieved by the companies in England and Wales in 2003-04 and 2009-10. We recalculate the scores for all of the English and Welsh companies to remove elements of the OPA that were not included in the index for Scotland⁶. On this basis the scores suggest that performance south of the border has remained stable. Having previously lagged behind the rest of the industry on customer service, Scottish Water is now firmly placed within the English and Welsh pack.

Figure 2: Comparison of Scottish Water’s OPA scores with performance in England and Wales

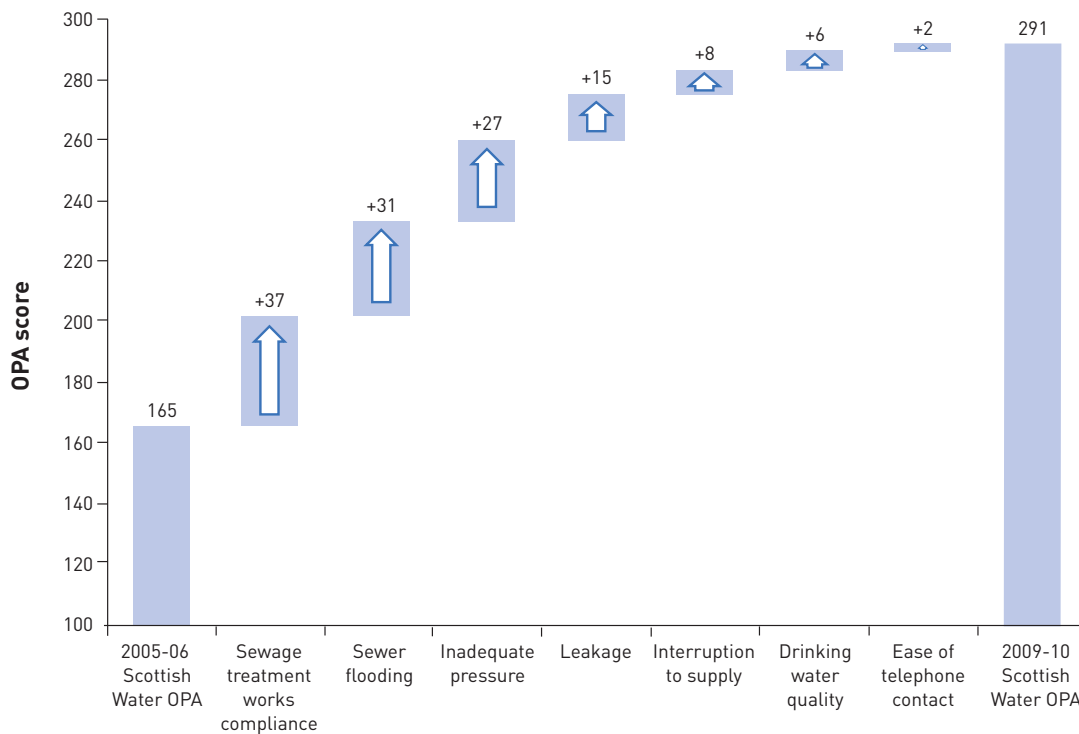


⁶ Measures that were excluded have formed part of Scottish Water’s OPA score since April 2010.

How Scottish Water performed on individual measures

Figure 3 shows the overall improvements achieved by Scottish Water on individual OPA measures over the regulatory control period 2006-10.

Figure 3: OPA improvements between 2005-06 and 2009-10 for individual areas of customer service



CUSTOMER SERVICE

The greatest improvement was in the area of sewage treatment works compliance. This is mainly because of improvements at Dalmuir wastewater treatment works, which is operated by a private contractor on Scottish Water’s behalf. Our final determination in November 2009 included an allowance to secure compliance at this works during the 2010-15 regulatory control period. We welcome the fact that this has been achieved at such an early stage. This demonstrates that determined management can put pressure on contractors to achieve compliance, and we expect this to continue going forward.

Table 1 shows Scottish Water’s performance on individual measures in 2009-10, the final year of the last regulatory control period 2006-10. There were improvements in five areas, while performance declined slightly in three. It should be noted, however, that in two of these areas performance remained above the average level in England and Wales.

Table 1: Performance on individual measures 2009-10

Measures where performance has improved	Measures where performance has been maintained	Measures where performance has deteriorated
Inadequate pressure	Hosepipe restrictions	Unplanned supply interruptions
Leakage	Sludge disposal	Ease of telephone contact
Sewer flooding		Response to written complaints
Drinking water quality		
Sewage treatment works compliance		

Table 2 compares Scottish Water's performance in 2009-10 with that of the average score achieved by the companies in England and Wales in the same year. Scottish Water's performance is ahead of the average score south of the border for some measures. However, for other measures, particularly unplanned supply interruptions, there is scope for Scottish Water's performance to improve.

Table 2: Comparison of Scottish Water's performance with the average score in England and Wales

Measures	Number of points <i>above</i> average score in England and Wales	Number of points <i>below</i> average score in England and Wales
Sewer flooding	18	
Ease of telephone contact	1	
Response to written complaints	1	
Sludge disposal	1	
Leakage		2
Drinking water quality		4
Inadequate pressure		5
Sewage treatment works compliance		7
Unplanned supply interruptions		8

Next steps

We welcome Scottish Water's commitment to, and outperformance of, the OPA targets. This has resulted in material improvements for customers in Scotland, many of which have been delivered without being required by the regulator and without any additional cost to customers.

Looking forward, and as outlined in our final determination, we now have every expectation that Scottish Water's performance will at least match that of the leading companies in England and Wales by 2013-14. We have set a target OPA score for that year in the range of 380 to 400.

IMPROVING EFFICIENCY

A key part of our role is to make sure that customers receive value for money. We do this by challenging Scottish Water to drive down its day-to-day running costs and deliver its capital programme more efficiently.

At both the 2001 and 2005 reviews (covering the regulatory control periods 2002-06 and 2006-10 respectively) we challenged Scottish Water to deliver very large improvements in both its operating efficiency and in delivering the capital programme. Scottish Water accepted these challenges, and customers' bills were set accordingly, taking full account of the required improvements.

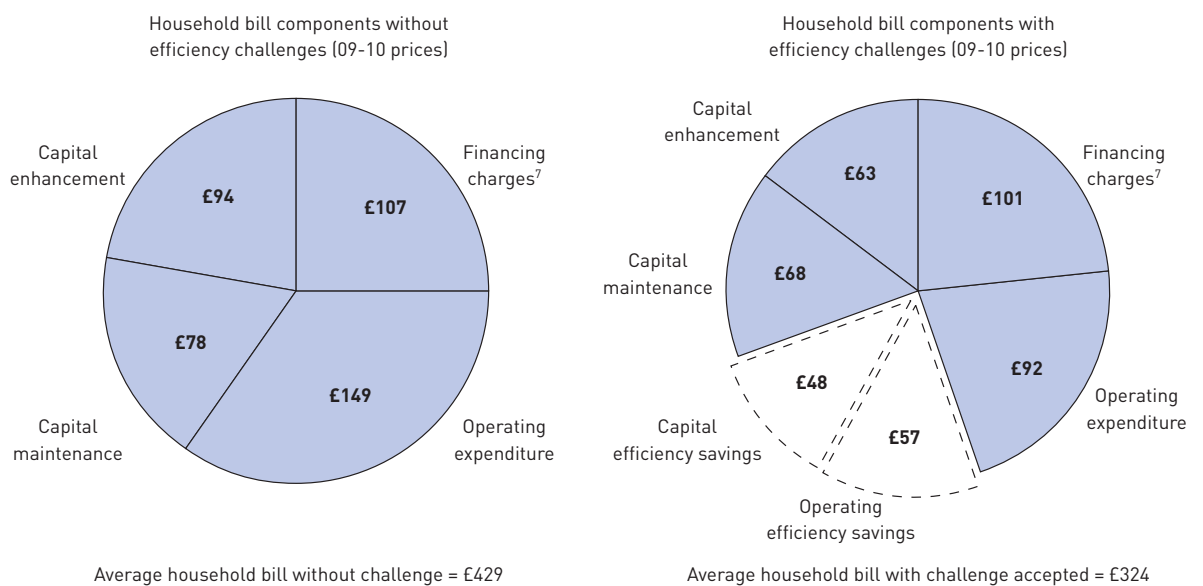
What this has meant for customers

The savings that we identified at the 2001 and 2005 reviews total around £2.5 billion. As a result of these savings, today's average household bills are around £105 lower than they would otherwise have been.

Of this, lower operating costs account for £57, while the other £48 of the reduction comes from improved planning and procurement of capital investment.

The savings are illustrated below. The first pie chart represents the average household bill as it would have been without our regulatory challenge (that is, £429 in 2009-10). The second shows the average household bill that actually applied (£324 in 2009-10).

Figure 4: Comparison of average household bills for 2009-10



⁷ Financing charges include tax, interest cost and movement in working capital.

Household bills are now lower in real terms than they were eight years ago, and are set to reduce by a further 5% by 2015. Some businesses and public organisations are seeing even larger reductions. The savings that have been delivered compare well with the cost to customers of our work in regulating the industry, which is around 60 pence a year per household.

Customers are not only getting better value for money because their bills are lower than they would otherwise have been. At the same time Scottish Water has also become more efficient in its overall management of the business. This includes delivering greater efficiencies in operating costs than the target levels we set (see below). These efficiency savings were captured at the 2009 price review and are being passed on to customers through the bills they are paying during the current regulatory control period (that is, 2010-15).

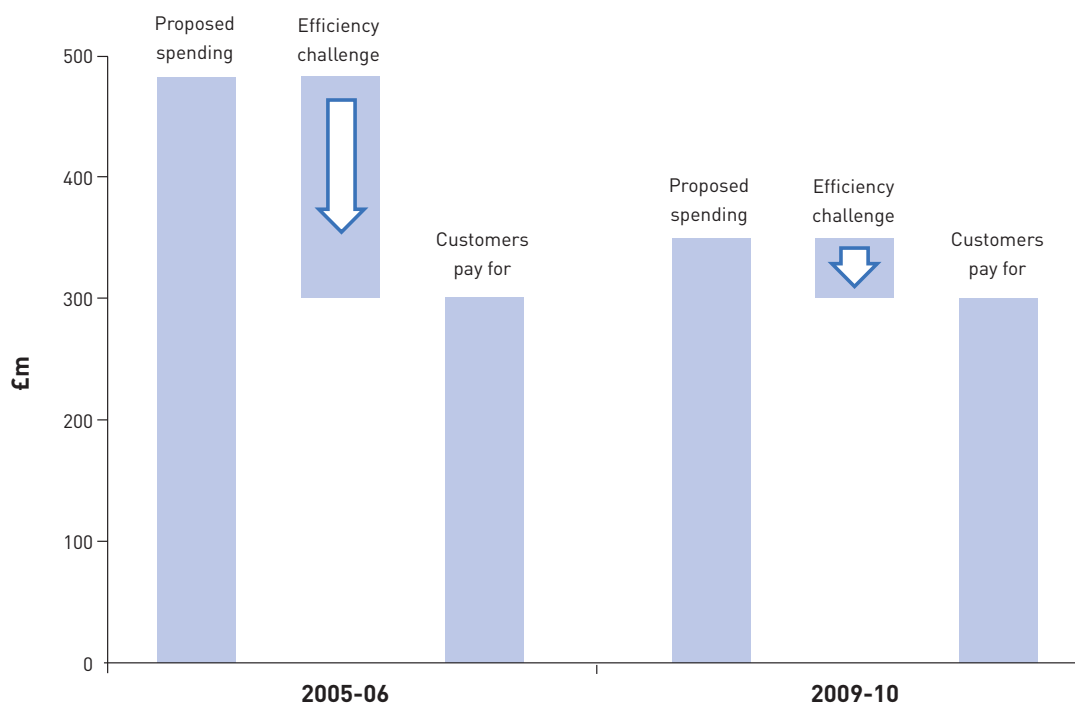
Our challenge: operating expenditure

In 2001 we challenged Scottish Water to improve its operating efficiency so that by 2005-06 its annual spend would be £177 million less than it proposed to spend, a reduction of 37%.

Then, in 2005 we challenged Scottish Water to improve further its operating efficiency, so that by 2009-10 its annual spend would be £58 million less than it proposed, a reduction of 16%.

Taken together, we estimate that these efficiency challenges would reduce annual spend by around £186 million by 2009-10, compared with the levels that would have prevailed had there been no regulatory efficiency challenge.

Figure 5: Our challenge on operating expenditure performance (annual)



How Scottish Water responded on operating costs

Scottish Water's operating costs are now around 35% lower than they were eight years ago. This transformation is unprecedented in the UK water industry. **It is all the more welcome given the improvements in OPA that have been delivered and in light of the fact that over the same period the water industry in England and Wales has seen its operating costs increase by 13%.**

Over the last eight years Scottish Water's performance on cutting its operating costs has generated around £1 billion of net savings⁸. Although customers will expect Scottish Water to continue to make savings in its operating costs there is now less scope for further significant reductions in these costs.

Scottish Water is continuing, however, to contain any increases in costs whilst at the same time improving its levels of service. Its expenditure remains within the levels that we assumed when setting prices for the 2006-10 period. Indeed, over that period Scottish Water has outperformed our challenge by a total of £31 million.

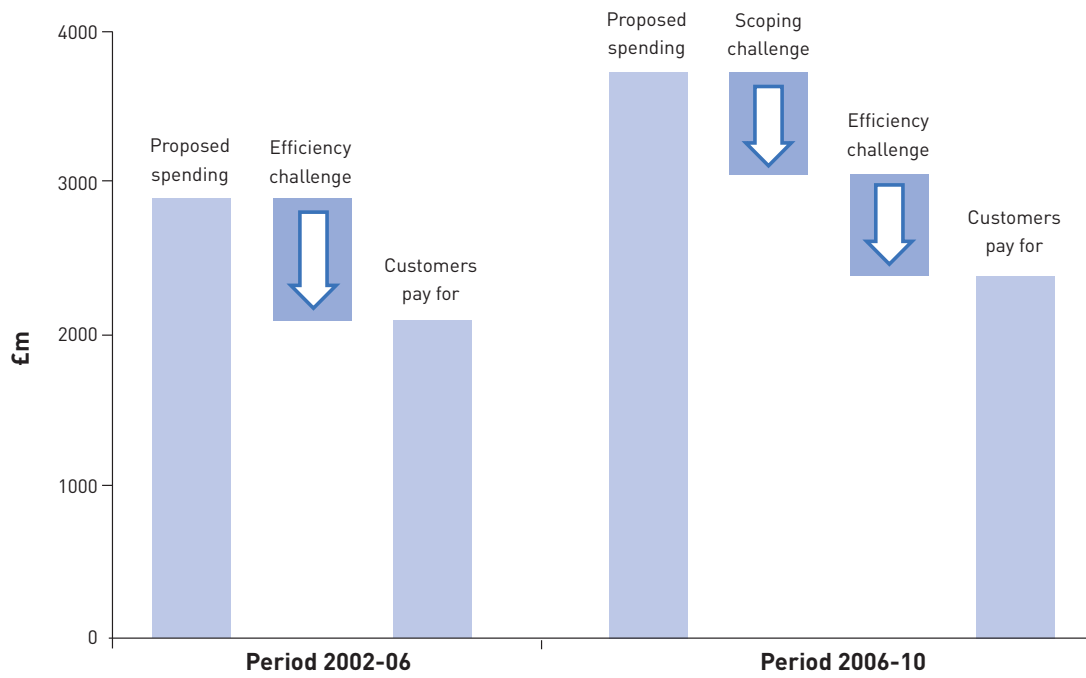
Our challenge: the capital programme

In 2001 we challenged Scottish Water to improve its overall efficiency in planning and procuring capital projects, and so reduce the cost of delivering its capital investment programme for 2002-06 by 23%. This represents a saving of £660 million in today's prices.

Then, in 2005 we examined Scottish Water's investment proposals for 2006-10. We identified and removed around £670 million of excess scoping and cost estimation. We then challenged Scottish Water to deliver a further 22% (£680 million) of planning and procurement efficiencies.

⁸ The net savings are calculated after subtracting £0.25 billion of exceptional restructuring costs.

Figure 6: Our challenge on capital expenditure performance (each four-year period)



How Scottish Water responded in delivering the capital programme

Scottish Water met our efficiency targets in planning and procuring capital projects over the eight-year period to 2010 and is delivering the outputs for the water industry required by Scottish Ministers broadly within the amount we allowed, when the outperformance in some areas of the programme is taken into account. In other words, the outputs will be delivered for around £2 billion less than originally forecast.

DELIVERING THE INVESTMENT PROGRAMME

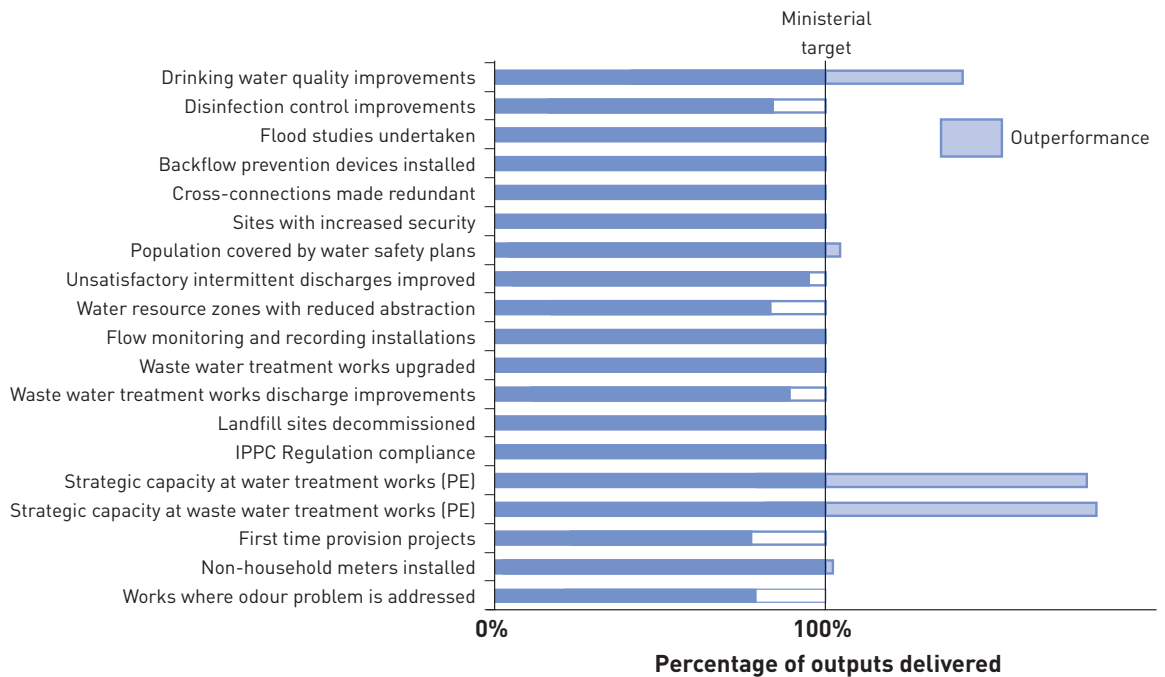
Progress in delivering the investment programme is measured against targets that are agreed by Ministers and set out in Scottish Water's delivery plan. These cover a range of different output categories that deliver improvements in drinking water quality, environmental performance and customer service.

It has been a challenge for Scottish Water to deliver the 2006-10 programme. This is largely because of the size of the programme, which was the largest in the UK on a per connected property basis, as well as the need to define requirements in some areas more clearly before delivery could start.

We raised our concerns about progress in earlier performance reports. Last year⁹, we noted that the pace of delivery had begun to increase but that significant scope remained for Scottish Water to improve the rate at which projects achieve the critical sign-off milestone (when the environmental and water quality regulators confirm that the output has been delivered).

We are pleased to report that Scottish Water made a significant improvement in its delivery performance in 2009-10, to the extent that at 31 March 2010 it had completed delivery of the vast majority of the programme, as Figure 7 shows.

Figure 7: Progress in delivering the 2006-10 programme at 31 March 2010



⁹ Investment report 2008-09, 4 November 2009.

Scottish Water has outperformed the ministerial objectives in several areas, delivering more outputs than were financed.

In other areas there is currently some shortfall against the objectives. This relates primarily to programme areas where study work was necessary in order to identify the most cost-effective solutions.

Scottish Water was also required to complete outputs during 2006-10 that remained from the previous (2002-06) period. Significant progress has been made, although some outputs have been delayed further by planning and land acquisition issues.

Areas where a shortfall remains have been captured and are being closely monitored through the Outputs Monitoring Group. This comprises the Scottish Government, Scottish Water, the Drinking Water Quality Regulator, the Scottish Environment Protection Agency, Waterwatch Scotland and the Commission. Significant progress is being made with completing the remaining projects, although it is forecast that some outputs will not be delivered until June 2013. Scottish Water has undertaken to deliver the projects within the resources allowed for the period 2010-15 (that is, at no additional cost to customers).

Next steps

Scottish Water is on target to deliver the whole programme, including the remaining projects from the previous investment period, broadly in line with the finance allowed in our November 2005 final determination. As noted above, it will also have delivered additional outputs, not included in the ministerial directions, within the resources originally allowed for.

TACKLING LEAKAGE

TACKLING LEAKAGE

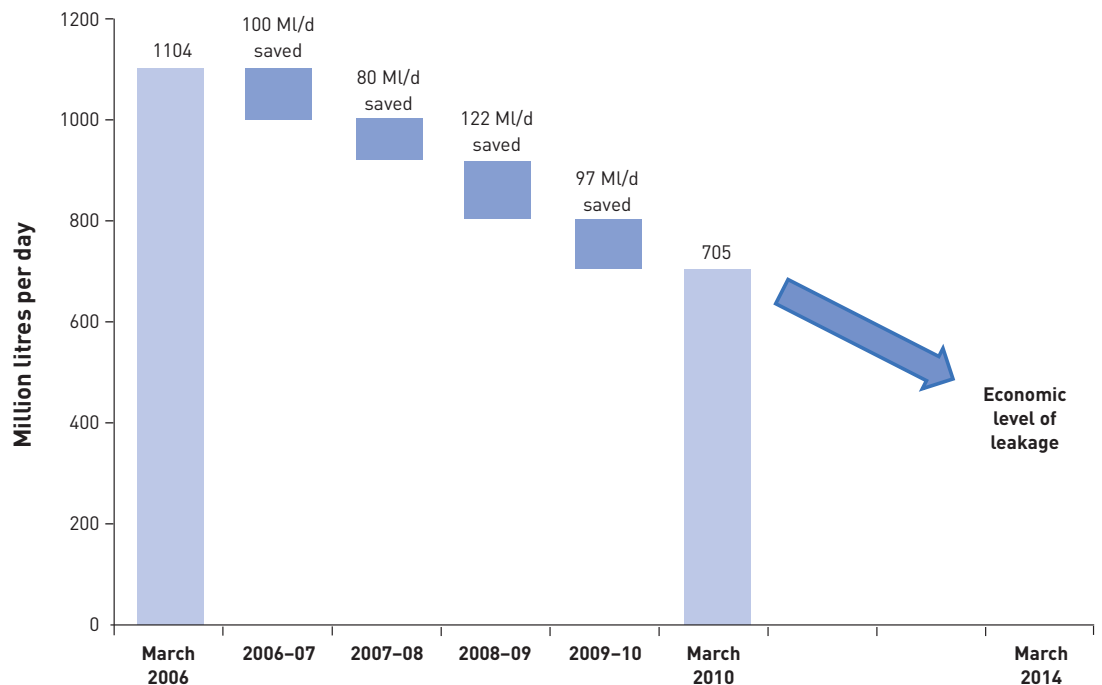
Leakage is the water lost in a water network before it reaches customers. It can arise from, for example, bursts in pipes or poor connections. Reducing leakage is not only economically justifiable – reducing operating costs and capital expenditure – but also helps Scottish Water to deliver its obligations on sustainable development and reduce its carbon emissions.

Scottish Water inherited historically high levels of leakage with poor leakage detection and repair systems in place. We have set annual targets for Scottish Water to reduce leakage since 2006. The targets are designed to ensure that by 2013-14 Scottish Water achieves the point where the cost saving of reducing leakage is equal to the economic cost of the water lost (this is known as the economic level of leakage).

After a slow start, Scottish Water managed to beat its leakage targets in both 2008-09 and 2009-10, the latter despite the severe winter weather experienced. Leakage is now more than a third less than its level of five years ago, as Figure 8 shows. This reduction in leakage is enough to supply half of Scotland’s households every day.

Looking forward, we expect Scottish Water to reduce its leakage by over a third again by the end of the 2010-15 regulatory period, but for this to have no upward impact on costs.

Figure 8: Scottish Water’s leakage performance

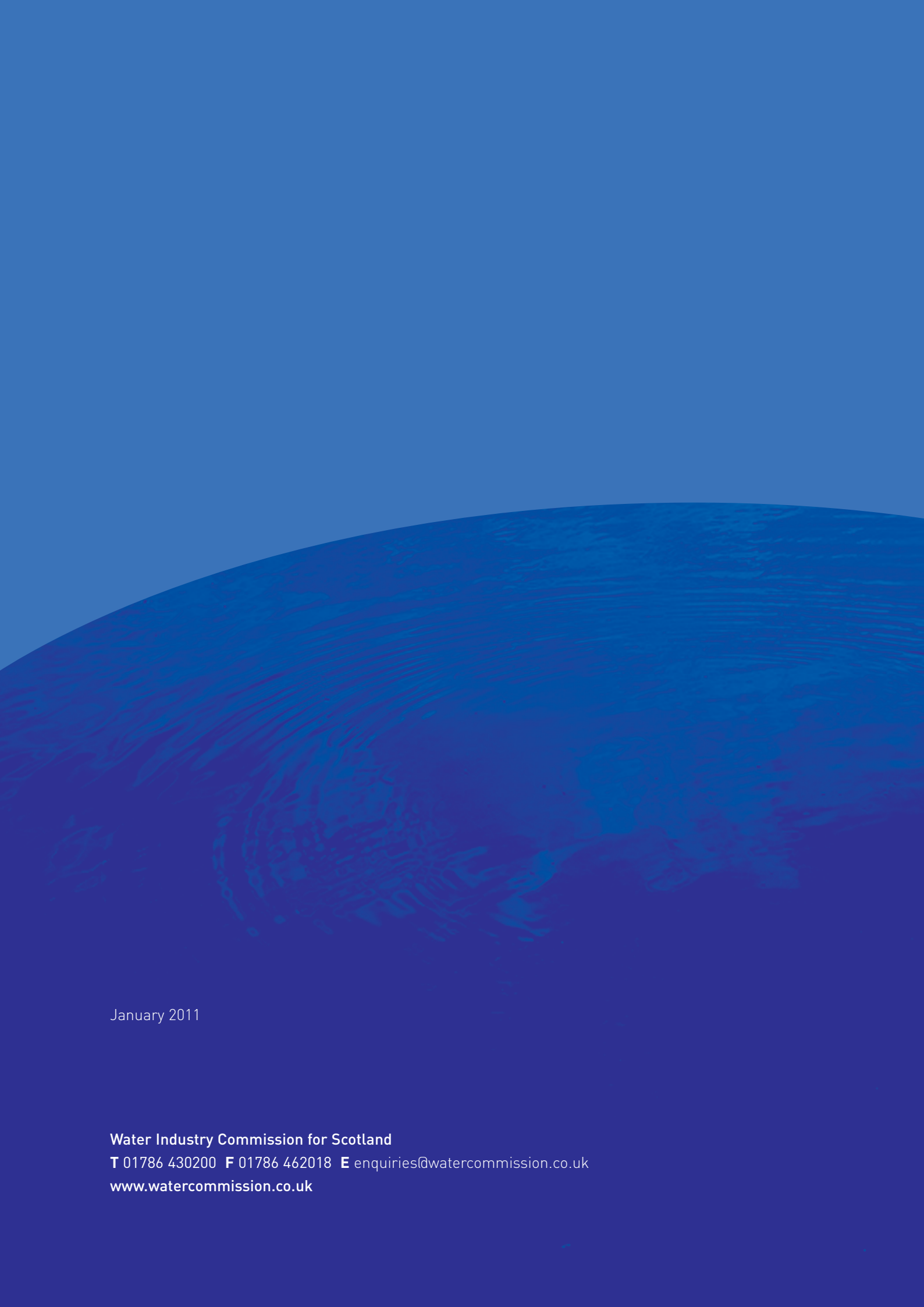


NEXT STEPS

We have started planning for the next price review process, when we will set charges for the period beyond 2015. We want to make sure that the industry is properly equipped to meet future challenges, including carbon reduction targets, affordability and changing customer expectations.

This work is likely to involve simplifying the regulatory system and encouraging greater customer participation. Along with other industry stakeholders we will also continue to monitor Scottish Water's performance to ensure that it remains on track.

NEXT STEPS



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