

ANNUAL REPORT 2006-07

ACHIEVING BEST VALUE FOR WATER AND SEWERAGE CUSTOMERS





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This annual report and accounts document for the period 1 April 2006 to 31 March 2007 is in draft and unaudited. Final versions of the annual report and accounts will be laid before Parliament following the completion of Audit Scotland's audit of our accounts.

WATER INDUSTRY COMMISSION FOR SCOTLAND

Our mission is to manage an effective regulatory framework which encourages the Scottish water industry to provide a high-quality service and value for money to customers.

Who we are

The Commission is a non-departmental public body with statutory responsibilities. We act independently of Ministers. In line with Better Regulation Task Force principles, we aim to be transparent, accountable, consistent, proportionate and well targeted in our actions.

Established in 2005, we took over responsibility for regulation of water and sewerage services from the former Water Industry Commissioner for Scotland. We are a small team of around 25 people, comprising the Chairman Sir Ian Byatt, the Chief Executive Alan Sutherland, the Commission members and members of staff.

What we do

We have a statutory duty to promote the interests of customers. We principally do this by setting prices for water and sewerage services that deliver Ministers' objectives for the water industry at the lowest reasonable overall cost.

Last year, we announced limits on the prices that Scottish Water can charge customers from 2006-07 to 2009-10. During this, the first year of the four-year review period, customer bills rose below the rate of inflation. Scottish Water has continued to improve its efficiency and has been tasked with delivering the largest investment programme per connected property in the water industry in Britain during 2006-10.

We are also facilitating the introduction of a competition framework in the Scottish water industry. We expect that competition in the retail non-household market will encourage further efficiency gains in the industry and provide customers with greater choice. This year we have made significant progress putting into place the key elements of an open, transparent licensing framework.

INTRODUCING OUR MEMBERS AND DIRECTORS



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01:

Sir Ian Byatt Chairman

Sir Ian Byatt was Director General of the Office of Water Services (Ofwat) between 1989 and 2000, where he was responsible for independent economic regulation of the water companies in England and Wales.

From 1978 to 1989 he served in HM Treasury as Deputy Chief Economic Adviser. Since 2000 he has advised the World Bank and governments around the world on matters relating to the water industry. Sir Ian, who was an adviser to the former Water Industry Commissioner from 2002, was knighted in 2000.

02:

Professor David Simpson Deputy Chairman

Professor Simpson was economic adviser to Standard Life from 1988 to 2001. He was the founding Director of the Fraser of Allander Institute at the University of Strathclyde and is a Trustee of the David Hume Institute.

Professor Simpson acted as an adviser to the Water Industry Commissioner for Scotland from 2002.

03:

Professor John K Banyard OBE

Professor Banyard is a chartered engineer who retired in December 2004 as an Executive Director of Severn Trent Plc following a career in the water industry. His particular areas of responsibility were the design and management of the capital programme, the day-to-day operation of the company's infrastructure, and R&D. He also acted as an adviser to the Water Industry Commissioner for Scotland from January 2005.

04:

Dr Mike Brooker

Dr Brooker is a scientist who retired as Managing Director of Welsh Water in 2005. During his career he was Chief Scientist and subsequently Divisional Operations Director of Welsh Water before becoming Managing Director in 1996.

05:

Charles Coulthard

Charles Coulthard was previously the Managing Director of Ofgem (the Gas and Electricity regulator) in Scotland. He served as Deputy Director of the Office for the Regulation of Electricity and Gas in Northern Ireland between 1992 and 1999. He is also currently the Chair of the Gas and Electricity Consumers Council in Scotland.

The Commission comprises a non-executive Chairman and four other non-executive Members. The Chief Executive is also a member of the Commission.



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06:

Alan Sutherland Chief Executive

Alan Sutherland was the Water Industry Commissioner from November 1999, when the position was created. During that time, he developed a framework for economic regulation of Scottish Water. He has extensive experience in management consultancy and in the investment banking industry, being a former management consultant with Bain and Company and before that a Manager with Robert Fleming and Company. More recently he was the Managing Director of Wolverine CIS Ltd, a division of Wolverine World Wide.

07:

Katherine Russell Director of Corporate Affairs and Customer Service

Katherine Russell's early career was in the financial services sector. She joined the staff of the Scottish Water and Sewerage Customers Council in 1996 which became the Water Industry Commissioner's

Office in 1999. Her responsibilities include finance, human resources, customer consultation and media relations. She is also Secretary to the Commission.

08:

John Simpson Director of Analysis

John Simpson has more than 25 years' experience in the water industry. He joined the Water Industry Commissioner's Office in 2000 from Ofwat, where he developed econometric benchmarking models for the 1999 price review and advised on efficiency targets for the water and sewerage companies.

09:

Jeremy Atkinson Director of Licensing

Jeremy Atkinson is a professional economist with 11 years' experience in utility economics. He joined the Water Industry Commissioner's Office in 2003 after working for the economic consultancy NERA, where he advised governments and private

sector clients on utility policy, specialising in water resource planning and tariff issues. During 2006-07 Jeremy successfully applied for the position of Chief Executive of the Central Market Agency for the new retail market. It is expected that Jeremy will take up his new position during 2007-08.

10:

Ian Tait Director of Investment and Asset Management

Ian Tait is a chartered engineer with more than 20 years' experience in the utility sector. Before joining the Water Industry Commissioner's Office in 2002 he worked for Scottish and Southern Energy in positions including Strategic Planning Manager and Transmission System Manager. He has particular experience in capital investment, asset management and connection charging regimes.

A GOOD YEAR CHAIRMAN'S FOREWORD



This has been a good year for customers of Scottish Water. Under the price limits set by the Commission on 30 November 2005, household customers have seen their bills rise by 3%, less than the rate of inflation, while bills have risen by 7% south of the border. Business and other non-household customers, such as hospitals and local authorities, have had increases held to 2%.

Customer service, while still not as good in Scotland as in England, has improved significantly. The constraints that have dogged developers for years have eased considerably.

This must not lead to self-congratulation, with the risk of complacency. Leakage remains too high and the large capital programme for the years 2006 to 2010 has got off to a slow start. The Commission is concerned both at this slow start and at the future prospects for financing it from public funds. Are Ministers prepared to guarantee that some £200 million a year will be forthcoming from the public purse for a long-term capital programme, or are they ready to see direct borrowing from capital markets?

During the year the Commission has put in place a regime for the supply of competitive retail services for 130,000 non-household customers, for both water supply and sewerage services. This will cover billing, value added services and complaints handling. In recent years, but no longer, business customers have seen substantial increases in bills to finance higher water quality and environmental standards. Competition now offers the prospect of better service and lower bills.

New retailers are now able to apply to the Commission for retail licences and we are pleased to see that Scottish & Southern Energy, the utility group, has expressed an interest in being the first private sector company to supply water across Scotland next year.

When the retail market opens in April 2008, we will shift to the control of wholesale charges – and the setting of a default tariff for retail customers that will ensure that no customer need ever be without a supplier.

We are already preparing for the next Strategic Review of Charges, for the period 2010 to 2014. A consultation on the approach and timetable has been completed. We have also begun to consult on the proposed methodology. We are very conscious of the need to continue with a large capital programme to improve water and environmental quality and to improve customer service. We are equally conscious of the wishes of customers not to see inflation-busting increases in their utility bills.

The Commission is particularly concerned that customers play a major role in the 2009 price review and will be working closely with Waterwatch Scotland, and with business and local authorities. There will also be a series of stakeholder information workshops.

The Commission has held 11 meetings during the year, with an average attendance of 5 Commissioners. Directors attend for discussion of issues within their areas of responsibility. Minutes of meetings are available on our website. There are two sub-committees, the Audit Committee chaired by Charles Coulthard and the Remuneration Committee that I chair.

To discharge our accountability to Scotland, I have met Members of the Scottish Parliament and, with the help of my advisor Neil Menzies, have visited local authorities, Chambers of Commerce, business associations and some large customers. Neil has extensive business experience and was formerly Deputy Chairman of the Scottish Water and Sewerage Customers Council.

We have been well served by the Office, under the management of our Chief Executive, Alan Sutherland. He has been a tower of strength, combining creative vision with analytical skills. He has built up an impressive team, well supported by consultants drawn from the relevant areas of professional expertise. We wish to thank them all for making this an exciting and productive place to work.

May I conclude by saying that we are proud of our part in Scottish Water's enhanced efficiency and improvement in its delivery to its customers and to the environment? Its success points the way to what the public sector in Scotland can achieve for the Scottish people.

The 2009 price review will be conducted openly, with maximum involvement from all interested parties.



Sir Ian Byatt
Chairman

RAISING THE BAR CHIEF EXECUTIVE'S REVIEW



Targets for the public sector water industry are no longer an aspiration but minimum levels of performance.

A changing industry

Regulation has transformed the public sector water industry in Scotland. It is a mere five years since Scottish Water was created. At that time, many commentators were of the opinion that Scottish Water would be unequal to the challenges set by the regulator. However, it has outstripped expectations by not only meeting but also outperforming its efficiency targets. This is the more remarkable if it is remembered that Scottish Water has delivered in four years an improvement in performance that the companies in England and Wales took around a decade to achieve. For customers in Scotland, it means that performance equal to the companies is now on the horizon.

How has this been achieved? It has been possible because we began by setting out some clear ground rules. We established the need for proper financial discipline, good quality management information and consistent measurement and reporting. Scottish Water's management was therefore clear about what they had to do – and the rewards and benefits of doing what was required.

Scottish Water's greater efficiency has allowed us to keep price increases below the rate of inflation, without compromising its financial position. The average household bill is already £90 a year less than it would otherwise have been.

Scottish Water has outperformed its operating cost targets, reducing costs by some £160 million a year or 40% in real terms. It has also made significant improvements in customer service, with a 24% increase in its 'OPA' score (the system we use to measure levels of service) between 2002-03 and 2005-06. Capital cost efficiencies now need more attention.

Monitoring progress

An interesting model is evolving in Scotland – one in which stakeholders measure delivery in terms of outputs rather than simply how much is being spent. In this model, everyone benefits if Scottish Water meets its performance targets and spends less than was allowed for.

We are a member of the Output Monitoring Group, which makes sure that Scottish Water is meeting its regulatory contract. The group is an important element of the transparent measurement of outputs (what is delivered for customers) rather than inputs (the resources committed by Scottish Water).

Scottish Water has now delivered 98% of the programme for 2002-06; it is our task to make sure that it completes the job. We are also keeping a close eye on its delivery of the programme for 2006-10 because there already appears to be some significant slippage. We have always been aware that delivering a capital programme of the size of Scottish Water's was bound to be a challenge. As we look forward we must question whether or not such levels of investment are deliverable at efficient prices.

Our price review allowed for Scottish Water to address development constraints across Scotland, enabling provision of 15,000 more homes a year in areas where there were previously constraints on development. During the coming year we will continue to work with Scottish Water to reduce leakage, and are carefully monitoring its water resource plans. We also await the outcomes of studies commissioned at the last review into unsatisfactory intermittent discharges.

Open for business

This year we have made good progress introducing competition into the retail business market. New retailers can now apply to us for a licence to sell water and sewerage services. If they receive a permanent licence before the market opens in April 2008, they can sign pre-agreements with eligible customers.

New entrants can be confident that they will be able to compete on a level playing field. Separation between Scottish Water's wholesale function (the operation of treatment works and its pipeline network) and its retail function (dealing with the end customer) is crucial to this. We have taken account of competition case law in finalising the agreements and codes that will underpin the new arrangements.

We believe the market power of a few other retailers is likely to put additional pressure on Scottish Water, as wholesaler, to improve its performance even more, which will clearly be to the benefit of both non-household and household consumers.

Like the high jump, incentive-based regulation rewards a good initial leap only with a further raising of the bar.

Preparing for the next price review

In November 2009 we will announce new price limits for the next regulatory control period, 2010-14. To this end, we have consolidated our own position by reorganising our staffing structure and recruiting new employees, both locally and from as far afield as Australia. We have also devised a performance appraisal system and agreed terms and conditions for our staff.

We published our proposed approach to the price review in December 2006 and received valuable feedback. We continue to consult on our methodology and confront the big issues affecting regulation of the Scottish water industry.

The improvement in performance that Scottish Water has achieved to date is clear, but there is no room for complacency. As Scottish Water improves, so the challenge of improving performance further increases. That will mean that we have to look again at the governance and incentives of the Scottish water industry and ensure that they are consistent with continuing value for money for customers.

A business of such a scale inevitably has economic, social and environmental impacts. We are mindful of the need to keep bills as low as possible – for today's customers and for future generations – and to make sure that we set charges that are broadly cost-reflective.

Conclusion

Regulating the monopoly that is the Scottish water industry is an interesting challenge. Effective efficiency incentives have to be developed while working within a public sector framework. The progress that has been made to date would not have been possible without the commitment and enthusiasm of our staff, and I thank them for their valuable service. I would also like to thank Sir Ian Byatt and the Commission members for their guidance and support.



Alan D A Sutherland
Chief Executive

AREAS OF ACTIVITY
2006-07



LOWER BILLS AND BETTER SERVICE BRINGING BENEFITS FOR CUSTOMERS

The regulatory framework in Scotland is bringing clear benefits for customers. By 2009-10, average household bills are likely to be the third lowest in the UK. Scottish Water is becoming more efficient – saving over £8 million a week in 2005-06 – and customer service is improving too. Yet despite increases in bills being held below the rate of inflation, there are record levels of investment to improve drinking water quality and environmental performance in Scotland.

Lower bills


This year was the first year of the new price limits we set for Scottish Water at our 2006-10 price review. Over the four-year period, bills for most household customers will increase at 0.5% below inflation. Bills for non-household customers will rise by 1.5% less than the rate of inflation. This compares positively with the situation south of the border. In the coming year, the average household bill in Scotland will be £15 lower than the average household bill in England and Wales.

Bills in Scotland are rising by less than the rate of inflation while financing a large environmental improvement programme.

Regulation, combined with the determined response of Scottish Water’s management, is creating demonstrable benefits for customers. At the close of the 2002-06 regulatory period, average water and sewerage bills for household customers were £90 lower than they would have been without the efficiency targets we set for Scottish Water. Business customers have also benefited because of the improvement in Scottish Water’s performance.

Household water and sewerage bills now compare well with other utilities in Scotland, as Table 1 illustrates.

Table 1: Comparison of average utility bills in Scotland

	2004-05	2005-06	2006-07
	£332	£384	£463
	£286	£313	£357
	£275	£282	£287

A more efficient industry

Lower bills are a direct result of Scottish Water becoming more efficient. It has responded well to the challenging but realistic targets that were set in 2001. It is making efficiencies in two key areas of the business:

- day-to-day running costs (or 'operating costs'); and
- the costs to maintain pipes, sewers and water treatment works (or 'capital costs').

During 2002-06, Scottish Water cut its annual running costs by almost 40%, beating the target it was set in 2001. The savings equate to just over £3 million a week (in 2005-06). Scottish Water has also achieved more than 20% better value for money in its capital costs since 2002, creating savings of around £5 million a week in 2005-06.

Better customer service

In September 2006 we published a report on customer service for the period 2002-03 to 2005-06. This showed that Scottish Water had improved its customer service performance – as measured by an 'overall performance assessment' (OPA) – by 24% in that time.

We reported that Scottish Water's service was improving in the following ways:

- drinking water quality;
- unplanned supply interruptions;
- response to written complaints; and
- response to billing contacts.

Measures that had deteriorated included:

- sewer flooding; and
- ease of telephone contact.

Although customers of the English and Welsh industry on average enjoy a better level of service than their Scottish counterparts, Scottish Water is catching up. We are encouraged that Scottish Water has embraced the OPA and that improving the level of service provided to customers will be an important factor in deciding whether to pay bonuses to staff.

At the same time as reducing its costs, Scottish Water is also delivering better levels of service to its customers.

During 2006-10, Scottish Water is expected to invest over £2 billion in its assets. It is important to customers that this money is spent efficiently and achieves the outcomes required by Ministers.

Targeted investment

Investment by Scottish Water is directed towards particular outputs, determined by Ministers, to improve drinking water quality, provide cleaner beaches and rivers, and bring better service for customers.

Our 'Investment and asset management report' (published in October 2006) reported that Scottish Water's investment during the period 2002-06 was delivering benefits for customers. In particular, Scottish Water had made significant progress in:

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

The benefits of this work have been noted by the quality regulators. The Drinking Water Quality Regulator (DWQR) stated that during 2005 "compliance with the drinking water quality standards improved". Similarly, the Scottish Environment Protection Agency (SEPA) has remarked that "all of Scotland's bathing beaches have passed the European standard water quality tests for the first time since monitoring began 20 years ago". We welcome these improvements.

Some of the outputs that Scottish Water was required to deliver during 2002-06 have met with delays and have not yet been completed. We are taking steps to ensure that customers get what they have paid for. In this regard, it is important to draw attention to our agreement with Scottish Ministers that customers should not pay twice for the same output. This is an important outcome for customers. It means that they will not be charged for any extra costs that result from delays in delivering the remaining outputs.

OUR ROLE IN THE INDUSTRY MAKING REGULATION WORK FOR CUSTOMERS

We use a number of tools – including the regulatory contract agreed at price reviews – to challenge Scottish Water to improve. We then monitor its performance to make sure that it responds positively to these challenges.

This year we were able to assess how well Scottish Water had responded to the 2002-06 review, and to begin to examine how it is responding to the 2006-10 review. We have also considered the regulatory tools we use and how these can be developed further.

Commitment to proportionate and effective regulation

We are committed to the Better Regulation Task Force's five principles of better regulation. These are: accountability, consistency, proportionality, targeting and transparency.

As Scottish Water's performance changes, it is important that our approach to regulation adapts with it. As part of our commitment to the principle of proportionality, during 2006-07 we undertook a review of the regulatory information we request from Scottish Water. Following this review we reduced the information we collect by around 30%.

Monitoring investment outputs

Our 2006-10 price determination was designed to ensure that Scottish Water delivered ministerial objectives on quality and better service to customers economically. Formal arrangements are now in place to make sure this happens.

Scottish Water's performance in delivering the outputs is monitored jointly by the Output Monitoring Group, which comprises representatives from the DWQR and SEPA, Waterwatch, Scottish Water, the Scottish Executive (on behalf of Scottish Ministers) and the Commission.

The group increases transparency for customers and stakeholders and ensures that Scottish Water is accountable for delivering the required outputs. The group meets every three months to review progress against ministerial objectives (which are set out in an agreed programme of works) and against interim milestones for output delivery (set out in Scottish Water's agreed delivery plan). It also oversees the process by which changes are made to the programme as a result of better information or revised priorities.

The Output Monitoring Group, with its focus on monitoring delivery, allows customers to see whether they have received the benefits of the investment they have paid for.

We believe that regular reporting of performance helps maintain appropriate stakeholder pressure on Scottish Water, and so benefits customers.

The group produces quarterly and annual reports on progress which allow customers and other stakeholders to see whether the improvements they are paying for are being delivered. During 2006-07 we have been concerned by evidence in these reports which suggests that Scottish Water has made a slow start to delivering its 2006-10 investment programme. The group will play a vital role in monitoring this situation in the coming year. We will also watch progress closely and publish more detailed information in our 'Investment and asset management report' in October 2007.

Encouraging greater efficiency

We not only monitor the outputs Scottish Water delivers to customers, but also the costs it incurs. We examine Scottish Water's expenditure on day-to-day operations and investment on an ongoing basis, and report Scottish Water's performance each year. This additional public scrutiny further encourages Scottish Water to make improvements.

2006-07 was an important year for our monitoring of Scottish Water's efficiency performance. For the first time we were able to gauge whether Scottish Water had met the regulatory targets set for the period 2002-06. We were pleased to report that for operating costs, Scottish Water had exceeded these targets.

In the coming year we will continue to monitor Scottish Water's cost performance and report how it has performed in the first year of the 2006-10 regulatory control period. Early indications suggest that savings achieved in 2002-06 were maintained in 2006-07. We will issue detailed information on performance in our 'Costs and performance report', which we will publish in November 2007.

Targeting levels of service and leakage

Measuring the level of service provided to customers on an objective basis can pose a challenge for regulators. We use the 'overall performance assessment' (OPA) framework, developed by Ofwat, to monitor the level of service that Scottish Water provides to its customers. The OPA combines individual service measures that customers consider to be most important, such as how quickly supply is restored after an interruption, how quickly Scottish Water handles complaints, and its performance in improving drinking water quality and environmental compliance.

At the 2006-10 price review we recognised, based on comparisons with England and Wales, that there was still substantial scope for Scottish Water to improve its levels of service to customers. We set Scottish Water milestones for improvement in its OPA score, with a target of a 40% improvement by 2010. This year Scottish Water has fully embraced this target.

We have also been working with the DWQR, SEPA and Waterwatch to align the OPA measures that we use with those that are reported in England and Wales, in preparation for the next price review.

In our last annual report, we discussed setting simple and pragmatic leakage targets for Scottish Water. Leakage is an important issue for customers and the environment. The 2006-10 price review financed Scottish Water to make significant progress in addressing leakage. In September 2007 we will report how well Scottish Water has performed against these targets.

During 2006-07 we have also worked with Scottish Water to establish a methodology to calculate the 'economic level of leakage' (this is the level of leakage at which further leakage control activity would cost more than other ways of bridging the gap between supply and demand). In the 2006-10 price review, we set Scottish Water the task of achieving this economic level by 2014.

COMPETITION

OPENING UP THE MARKET

Next year, all non-household customers, whatever their size or location, will be able to buy their water and sewerage services from retailers other than Scottish Water. We have made good progress establishing the licensing framework and underlying principles that will guide the market's development.

The introduction of competition to the Scottish water industry will mean that non-household customers will, for the first time, be able to choose the supplier who best meets their needs. The Commission is responsible for implementing the framework set out in the Water Services etc. (Scotland) Act 2005. We will license participants in the market.

We defined retail as including all customer-facing activities, for which a new entrant to the market could reasonably want to take responsibility. It includes billing, all other customer service activities and liaison with the customer on operational issues. Scottish Water will continue to be responsible for operating the water and sewerage networks and treatment plants.

Competition should bring wider choice, lower prices, better services and increased innovation.

Benefits for customers

We believe that the introduction of competition will be beneficial to customers. Non-household customers are likely to see many of the same benefits that they enjoyed after the energy markets were opened to a similar form of competition. This could include lower prices, better quality services and the opportunity to pick and choose between different service providers offering a range of service options.

For retailers there will be the opportunity to compete for a new market of some 130,000 non-household customers. Retailers will also have the opportunity to work with their customers to identify opportunities to reduce the wholesale costs of the water and sewerage service provided. Such savings would allow a lower wholesale charge to be established for that individual customer. This should certainly lead to lower costs for the customer but potentially also a more tailored and appropriate level of service.

Scottish Water's household customers should also benefit. Although Scottish Water will continue to provide retail services to households, these customers are also likely to see benefits from greater competition because there will be additional pressure on Scottish Water to improve its efficiency. The separation of the retail and wholesale functions should allow retailers to offer more innovative solutions to customers. This may include more extensive water efficiency advice.

Progress this year

To make informed choices, and negotiate the best deals, non-household customers and retailers who operate in the market require a clear framework to be established. This clear framework should make it easier for a new entrant to win customers as there will be no need to enter a specific negotiation over each potential new customer. This year we have put in place many of the codes and procedures that will support the market. Important developments include the following:

- Work to establish a Central Market Agency (CMA) to facilitate the efficient transfer of customer information. The CMA will enable customers to exercise the choice that the market provides by easing the process of switching retailers.
- Wide-ranging consultation on important elements of the framework. We conducted six consultations to understand the views of potential entrants and customers on elements of the framework, including market codes, licence conditions and application packs.
- Initiation of a project with Scottish Water to develop a wholesale charges scheme. The scheme will set out the charges that Scottish Water is able to make to licensed retailers for wholesale services.

Widening our perspective

We recognise the importance of understanding what arrangements potential entrants and current customers would hope to see in the market. In April 2006 we established a Licensing Framework Implementation Group (LFIG) to contribute to the development of various elements of the licensing framework. The LFIG consists of members drawn from different stakeholder groups, including the existing industry in Scotland, 'incumbent' water companies in England and Wales, licence applicants in England and Wales, and customer representative groups. Members of the LFIG have used their experience of the water and other utility industries to make a significant impact on the form the market will take. We are grateful for the valuable contribution they have made.

Granting provisional licences to SWBS

Under the provisions of the 2005 Act, Scottish Water is required to establish a separate entity to provide retail services to non-household customers. During 2006-07, Scottish Water Business Stream (SWBS) was created.

In October 2006, we awarded SWBS with provisional licences to provide water and sewerage services. This was an important step in the development of the market.

In order to be awarded a permanent licence, SWBS must demonstrate its compliance with three tests. They are:

- a financing test;
- a test that management and governance of Scottish Water and SWBS have been properly separated and are seen to be so; and
- a test that costs and activities have been appropriately allocated between Scottish Water and SWBS.

Open for business

In January 2007 our statutory powers to license retailers (other than SWBS) into the market came into force. This means that we are now able to receive and process licence applications and award licences. During 2007-08 licensees will be able to compete for, and negotiate with, non-household customers. Any agreements formed will come into effect on 1 April 2008 when the market opens fully.

We are also able to award self-supply licences. There are a number of organisations in Scotland that are large users of water on multiple sites. These organisations may find benefit in applying for a licence to 'self-supply'. This would involve receiving wholesale services direct from Scottish Water in return for a wholesale charge. Self-suppliers would provide their own retail services, for instance, generating their own billing information.

This is an important opportunity for the Scottish water industry. We look forward to new entrants participating in the market and bringing choice to customers.

Competition will generate new incentives for the Scottish water industry to improve. This impulse for greater efficiency and more innovation should ultimately benefit customers.

ENGAGING STAKEHOLDERS BUILDING AN UNDERSTANDING OF OUR WORK

Two-way communication between regulators and stakeholders, particularly customers, is an important part of effective regulation. We try to explain our work in a clear, concise way and take account of the feedback we receive.

Improving the way we communicate

During summer 2006 we commissioned an external communications consultancy to scrutinise independently how we communicate with stakeholders and customers. They interviewed a wide range of people who provided useful feedback. We would like to thank all those who took part.

The key recommendations of the review were that we should:

- strengthen the way we communicate with our co-regulators and Scottish Water;
- present clearer, more targeted messages about our work to customers and to stakeholders;
- improve the accessibility of our publications; and
- upgrade and redesign our website.

We have taken steps this year to act on these recommendations. In particular, we have stepped up the number of one-to-one meetings we hold with stakeholders, developed our IT systems, improved the clarity of our publications, and initiated a redesign of our website.

Strengthening our links with stakeholders

We are just one component of Scottish Water's overall regulatory framework. In order to be effective at our job, it is important that we keep up to date with our co-regulators and the issues affecting their work. In light of the communications review, this year we have increased the number of times we meet with our co-regulators including SEPA and the DWQR. We also held regular liaison meetings with Scottish Water at different working levels.

We meet as many stakeholders as possible to explain in person important policy changes or developments. Provisions in the Water Services etc. (Scotland) Act 2005 relating to the introduction of retail competition arrangements will have an impact on Scottish Water's business customers. This year we exposed issues with the way Scottish Water charges customers for trade effluent and proposed remedial changes. To explain the impact of these changes and canvass views, our Chairman and his advisor Neil Menzies met eight local authorities and 16 business organisations during the year.

This year we met local authorities and business organisations to explain policy changes and hear about local issues.

Table 2: Meetings with local authorities and business organisations

Meeting	Date
Scottish National Farmers' Union	27 June 2006
Institute of Directors	28 June 2006
Scottish Chambers of Commerce	28 June 2006
Convention of Scottish Local Authorities	29 June 2006
Universities Scotland	29 June 2006
Scottish Borders Council	25 July 2006
Scotch Whisky Association	26 July 2006
Glasgow Chambers of Commerce	27 July 2006
Glasgow City Council	14 August 2006
Scottish Churches Industrial Mission	15 August 2006
City of Edinburgh Council	15 August 2006
North Ayrshire Council	16 August 2006
North Lanarkshire Council	16 August 2006
Confederation of British Industry	18 September 2006
Scottish Enterprise	19 September 2006
Scottish Engineering	20 September 2006
Glasgow City Council	20 September 2006
Dundee City Council	16 October 2006
Scottish Building Federation	18 October 2006
Perth and Kinross Council	20 November 2006
Aberdeen Fish Processors	21 November 2006
Aberdeen and Grampian Chamber of Commerce	21 November 2006
Chemical Industries Association	22 November 2006
Highland Council	20 February 2007
Highlands and Islands Enterprise	20 February 2007

Consulting stakeholders

We use formal consultations to take account of the views of customers before making policy decisions that could affect them. During the year, we issued ten consultations relating to areas of our work – ranging from trade effluent charging to our fees scheme for licence applications.

In December 2006 we undertook the first consultation on the next price review. We emphasised our commitment to making the price review as transparent as possible. We asked for views on how we proposed to communicate with stakeholders, the timeline for the review and the issues the review will cover.

As part of our commitment to an open, transparent regulatory business, we consult widely on our key areas of work.

Table 3: Consultations issued during 2006-07

Work area	Consultation	Purpose
Competition	Materials for applicants	Sought views on the first section of information that would be included in licence application packs.
Competition	Fees scheme for SWBS	Sought views on the fees scheme that would be used to process SWBS' provisional licence application.
Competition	Section 29E process	Sought initial views on the process for assessing applications for departures from the wholesale charges scheme.
Competition	Disconnections code	Sought views on a disconnections code for non-household customers.
Competition	Market arrangements	Sought views on proposed arrangements for the retail market.
Competition	Fees scheme	Sought views on the fees scheme that would be used to process licence applications.
Monitoring delivery	Reasonable cost determinations	Sought views on the process for assessing appeals regarding the level of 'reasonable cost' contribution made by Scottish Water for the connection of new premises to the network.
Monitoring delivery	Trade effluent	Sought views on issues relating to the way Scottish Water charges for trade effluent services.
Monitoring delivery	Draft wholesale charges scheme	Sought views on Scottish Water's draft wholesale charges scheme for the retail market.
Setting prices	Our approach to the 2010-14 price review	Sought views on the timetable for the next review and how we proposed to communicate with stakeholders.

Improving our publications

This year, in line with the recommendations of the communications review, we overhauled the presentation and style of our publications. We took account of stakeholders' comments that our documents could be shorter and more concise by publishing summary documents. We changed the design of our documents to present clearer key messages. We are also implementing a bespoke document planning and production system which will ensure that our publications are produced in a standard format.

We remain committed to ensuring that our work is as transparent as possible. Many stakeholders are interested in the more detailed or technical aspects of our work, so we continue to publish supporting information notes on our website.

Updating our website

This year we have started work on developing our new website. We will be implementing the feedback we received from the communications review, as well as suggestions from stakeholders who responded to our consultation on the approach to the 2010-14 price review.

Presentations and seminars

We aim to raise awareness of how the regulatory model in Scotland has benefited customers and could be applied elsewhere, by giving lectures and presenting at seminars. During 2006-07, we gave presentations at eight events. This included events hosted by the London Business School (the Beesley lectures), the European Policy Institute and Water UK.

The Comiston lecture

The Comiston lecture is a well-established platform for discussing the water industry and regulation in general. This year's guest speaker was Philip Green, Chief Executive of United Utilities Plc. He gave a presentation entitled 'Improving performance – from vision to reality' to an invited audience of more than 100.

Freedom of Information and enquiries

As a public sector body, all of our work should be open to scrutiny. The Freedom of Information (Scotland) Act 2002 gives the public a general right of access to the information we hold. In 2006-07 we received 40 requests for information under this Act. All requests were responded to within 20 working days. We also updated our publications scheme. Our new scheme was approved by the Scottish Information Commissioner.

We also respond to general telephone and email enquiries about our work. In 2006-07 we received 40 email enquiries.

RUNNING THE OFFICE

THE RESOURCES WE USE

The coming year will bring some important challenges for our office as work on the 2010-14 price review accelerates and we prepare for competition in the retail market.

This year we have taken steps to strengthen our office to ensure that we are able to respond effectively to these challenges. This included increasing the number of analytical staff we employ and introducing new terms and conditions. We are well placed to ensure that we can continue to fulfil our duty to promote the interests of customers during 2007-08.

We have strengthened our office so that we can respond effectively to future challenges.

Supporting our staff

We aim to maximise our staff's potential by making sure that they are well supported and rewarded, and have opportunities to maximise their personal development. During 2006-07 we successfully implemented a new appraisal system. The system was developed internally by a staff working group. It provides a transparent and equitable means of assessing staff performance and development needs.

We also improved the policies and procedures in place to support staff, including implementing new terms and conditions, contracts of employment and a new staff handbook.

Staff recruitment

We believe that in order to continue to deliver value for money for customers we need high calibre staff who are able to challenge regulatory assumptions, develop new approaches and respond to customers' needs.

We have significantly strengthened our pool of analytical resources in advance of the next price review. We recruited four new analysts and two new analytical assistants during 2006-07. We also strengthened our Corporate Affairs team by recruiting a Human Resources Manager, an IT assistant and an office assistant.

Developing our IT systems

This year we continued to upgrade our IT systems. We also explored how IT solutions can help us to conduct the next price review in an effective and transparent way. We have also started work developing our new website.

The bespoke document planning and production application that we purchased this year, following the independent communications review, will ensure a transparent audit trail for the publication creation process, as well as reducing end production costs.

Governance

During 2006-07 the Commission's Audit and Remuneration Committees continued to meet on a regular basis. These committees provide independent advice to the Commission. They also provide additional scrutiny to ensure that our resources are used and developed effectively.

Preparing for the CMA

This year we have refurbished an area of our office in order to create new premises for the CMA. This included developing new and independent IT and telecommunications infrastructures. These assets will be transferred to the CMA company upon its creation during 2007-08.

LOOKING FORWARD NEW CHALLENGES

2007-08 will be an important year for the Scottish water industry and its customers. By the end of the financial year the retail market will open fully; for the first time, non-household customers should be able to choose their retailer. There will be significant developments for household customers too. If Scottish Water is able to sustain and exceed its current improvements in performance, customers should reap the benefits through better levels of service.

In 2007-08 we will finalise arrangements for the new market, to ensure that retailers have sufficient information to decide if they wish to apply for licences. Preparations for the next price review will gather pace this year too. In terms of our ongoing monitoring work, we will continue to analyse Scottish Water's performance in a rigorous and objective way, and to publish our findings.

The build up to market opening

We begin 2007-08 in a position to award licences to market entrants. Successful licence applicants will be able to compete for customers and negotiate pre-agreements during 2007-08. On 1 April 2008, when the market opens, these agreements will take effect.

Market opening should provide an attractive opportunity to new entrants to offer customers improved value for money, either in new and improved levels of service or lower prices. This year we have consulted with potential entrants and Scottish Water in order to develop the key components of the market framework. In doing so, we sought to ensure that new entrants can have confidence that the new playing field is level. During 2007-08 we aim to further raise awareness with both customers and potential licence applicants about the opportunities that exist for them under this new framework.

This year the focus of our work is on the methodology for the 2009 price review.

Raising the bar: the 2010-14 price review

We will publish the outcome of our next review, covering the four-year period from 2010-11 to 2013-14, in November 2009. We have already made good progress by consulting on our overall approach in December 2006. We received 14 written responses to this consultation. We published our decision paper in May 2007. All of the responses are available in full on our website at www.watercommission.co.uk.

We hope that following our consultation, stakeholders have a good understanding of how each stage of the review will be conducted and when. Importantly, we hope stakeholders understand how they can take part in and influence the review process.

During 2007-08, the focus of the office will be to develop further our methodology for the review. We begin the year by publishing a consultation in four volumes. We are seeking stakeholders' and customers' views on the methodology for conducting the four main areas of the review:

- governance and incentives;
- levels of service;
- operating costs; and
- capital expenditure.

The closing date for responses to all four volumes is Friday 19 October 2007. We encourage all stakeholders to express their views.

We have arranged a series of eight stakeholder information workshops. We welcome participation from stakeholders at these open forums. We will publish information about each event one week in advance and will place a note of each meeting on our website after the events.

As the year draws to a close, we will complete the methodology consultation process by considering carefully the responses we have received and publishing our conclusions on 20 December 2007.

The timeline for the review, including publication of our methodology consultations and decision papers, and the stakeholder information workshops, is set out overleaf.

Table 4: Timeline of key milestones

Event or activity	Proposed date
Consultation on our proposed approach closes	30 March 2007
Stakeholder information day 1 to discuss Volume 1 of our methodology for the price review, which will cover how Scottish Water is financed	12 April 2007
Publish methodology Volume 1: Financing Scottish Water	10 May 2007
Stakeholder information day 2 to discuss Volume 2 of our methodology for the price review, which will cover customer revenue and levels of service	10 May 2007
Publish our decisions on the proposed approach to the price review	24 May 2007
Publish methodology Volume 2: Customer revenue and levels of service	31 May 2007
Stakeholder information day 3 to discuss Volume 3 of our methodology for the price review, which will cover Scottish Water's operating costs	31 May 2007
MSP update	27 June 2007
Publish methodology Volume 3: Operating costs	28 June 2007
Stakeholder information day 4 to discuss Volume 4 of our methodology for the price review, which will cover Scottish Water's capital expenditure	28 June 2007
Publish methodology Volume 4: Capital expenditure	26 July 2007
Stakeholder information day 5, a follow-up on our methodology consultation Volume 1 on financing Scottish Water	26 July 2007
Stakeholder information day 6, a follow-up on our methodology consultation Volume 2 on customer revenue and levels of service	16 August 2007
Stakeholder information day 7, a follow-up on our methodology consultation Volume 3 on operating costs	30 August 2007
Stakeholder information day 8, a follow-up on our methodology consultation Volume 4 on capital expenditure	20 September 2007
MSP update	17 October 2007
Close of consultation on methodology Volumes 1, 2, 3 & 4	19 October 2007
Scottish Executive publishes consultation on principles of charging	1 November 2007
We publish our decisions on the methodology for the price review	20 December 2007
We issue guidance to Scottish Water on its first draft business plan	20 December 2007

Table 4: Timeline of key milestones (continued)

Event or activity	Proposed date
Close of Scottish Executive consultation on the principles of charging	1 February 2008
Scottish Executive publishes decisions on the principles of charging	1 April 2008
MSP update	2 April 2008
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 day 9 to discuss governance and incentives	15 January 2009
Stakeholder information day 10 to discuss how price limits are calculated	5 February 2009
Stakeholder information day 11 to discuss customer service	26 February 2009
Stakeholder information day 12 to discuss investment and quality	12 March 2009
Scottish Water submits its second draft business plan	13 March 2009
Stakeholder information day 13 to discuss supply and demand/water resources	9 April 2009
Stakeholder information day 14 to discuss capital maintenance	30 April 2009
Stakeholder information day 15 to discuss operating cost efficiency	21 May 2009
Stakeholder information day 16 to discuss capital expenditure efficiency	11 June 2009
We publish our draft determination of price limits for 2010-14	30 June 2009
Stakeholder information day 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 day 18 to discuss our final determination	30 November 2009
MSP update	30 November 2009

FINANCIAL REVIEW

2006-07



FINANCIAL YEAR 2006-07

PRO FORMA FINANCIAL INFORMATION

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 2007

	Notes	£
Income		
Scottish Water statutory contribution		2,751,592
Central Market Agency		1,479,258
Other income		38,470
Total income		4,269,320
Expenditure		
Staff remuneration and recruitment	1	1,141,319
Staff travel and subsistence		25,197
Accommodation		159,078
General operating costs		342,375
Consultancy projects		1,231,417
Recruitment		103,279
Information project & IT support		42,295
Strategic Review of Charges		11,408
Licensing		1,480,658
Central Market Agency		396,813
Non-cash costs (eg depreciation)		58,282
Finance charges		2,231
Total expenditure		4,994,352
Net deficit		(725,032)

The results include income of £1,479,258 and expenditure of £396,813 in respect of the Central Market Agency, which was under the responsibility of the Commission during the year.

In line with changes to the Financial Reporting Manual in 2006-07, grant-in-aid received from the Scottish Executive has now been shown as a financing flow and no longer as income. Grant income of £1,710,304 in 2006-07 has instead been credited to the General Reserve.

UNAUDITED BALANCE SHEET AS AT 31 MARCH 2007

	Notes	31 MARCH 2007 £
Fixed assets		
Tangible assets	2	193,535
Current assets		
Debtors & prepayments		88,171
Cash at bank and in hand		1,549,115
		1,637,286
Current liabilities		
Creditors: amounts falling due within one year	3	(773,627)
		863,659
Net assets excluding pension assets and liabilities		1,057,194
Pension assets		1,045,000
Pension liabilities		(1,240,000)
Net assets including pension assets and liabilities		862,194
Capital and reserves		
General reserve	4	862,194

**NOTES TO THE UNAUDITED FINANCIAL STATEMENTS FOR
THE YEAR ENDED 31 MARCH 2007**

1. Staff

The aggregate cost of remuneration comprises:

	YEAR ENDED 31 MARCH 2007
	£
Employees' remuneration	1,250,424
Remuneration paid on behalf of the Water Customer Consultation Panel deducted from levy payments made to them	(230,350)
Central Market Agency remuneration included under Central Market Agency expenditure in the Income and Expenditure account	(18,583)
	1,001,491
Employer's National Insurance contributions	89,811
Current service costs and amounts payable to defined contribution scheme	50,017
Amounts included within operating profit	1,141,319

The average number of staff employed in the period by the organisation was 18 (including the Chief Executive). Staff were employed in the following areas:

	YEAR ENDED 31 MARCH 2007
Directors, including Chief Executive	5
Corporate Affairs	9
Analysis	4

2. Tangible fixed assets

	EQUIPMENT £	FURNITURE & FITTINGS £	TOTAL £
Cost			
At 1 April 2006	171,666	193,348	365,014
Additions	40,376	37,441	77,817
Disposals	–	–	–
At 31 March 2007	212,042	230,789	442,831
Depreciation			
At 1 April 2006	109,122	81,892	191,014
Charge for the year	38,278	20,004	58,282
Eliminated on disposals	–	–	–
At 31 March 2007	147,400	101,896	249,296
Net book value at 31 March 2007	64,642	128,893	193,535

3. Creditors: amounts falling due within one year

	AS AT 31 MARCH 2007 £
Trade creditors	407,126
Accruals and other creditors	366,501
	773,627

4. Capital and reserves

	GENERAL RESERVE EXCLUDING PENSION RESERVE £	PENSION RESERVE £	GENERAL RESERVE INCLUDING PENSION RESERVE £
Balance as at 1 April 2006	111,922	5,000	116,922
Deficit for the year	(765,032)	40,000	(725,032)
Grant income from Scottish Executive	1,710,304	-	1,710,304
Recognition of other recognised gains and losses	-	(240,000)	(240,000)
Balance as at 31 March 2007	1,057,194	(195,000)	862,194





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