

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.

ANNUAL REPORT 2005-06: PUTTING OUR MISSION INTO PRACTICE

FOR THE PERIOD 1 APRIL 2005 TO 31 MARCH 2006

Laid before the Scottish Parliament by the Scottish Ministers under Part 1, section 5(4) of the Water Industry (Scotland) Act 2002 (As Amended).

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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 WILL BE TRANSPARENT, ACCOUNTABLE, CONSISTENT, PROPORTIONATE AND WELL TARGETED IN OUR ACTIONS.

We were established on 1 July 2005, taking 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 achieve best value for customers. We do this by setting prices for water and sewerage services that deliver Ministers' objectives for the water industry at the lowest reasonable overall cost.

Our first major act was to set limits to the prices Scottish Water can charge customers for the four years from 2006-07 to 2009-10. The prices we set represented good news for customers, with bills for most household and non-household customers rising below the rate of inflation over the four-year period.

We are now working with the quality regulators and Waterwatch Scotland to monitor Scottish Water's performance and to ensure that it delivers all that is expected of it within the price limits.

We also have a role in facilitating competition in the Scottish water industry. Competition will promote further efficiency gains and, where practicable, further choice for customers.

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INTRODUCING OUR MEMBERS AND DIRECTORS



SIR IAN BYATT, CHAIRMAN

Sir Ian Byatt was Director General of the Office of Water Services (Ofwat) between 1989 and 2000. In that role 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 Water Industry Commissioner from 2002, was knighted in 2000.

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.

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 former Water Industry Commissioner for Scotland from 2002.

DR MIKE BROOKER

Dr Brooker is a scientist who recently retired as Chief Executive of Welsh Water following a career in the water industry in Wales. During his career he was Chief Scientist and subsequently Divisional Operations Director of Welsh Water before becoming Managing Director in 1996.

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 a Managing Director of Wolverine CIS Ltd, a division of Wolverine World Wide.

CHARLES COULTHARD

Charles Coulthard retired recently as 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.



**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.

**JOHN SIMPSON,
DIRECTOR OF ANALYSIS**

John Simpson has more than 20 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.

**JEREMY ATKINSON,
DIRECTOR OF LICENSING**

Jeremy Atkinson is a professional economist with ten 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.

**IAN TAIT,
DIRECTOR OF INVESTMENT
AND ASSET MANAGEMENT**

Ian Tait is a chartered engineer with over 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.

DETERMINATION AND DELIVERY

CHAIRMAN'S FOREWORD



- **THE COMMISSION WAS APPOINTED ON 1 JULY 2005 AND IS CHARGED WITH PROMOTING THE INTERESTS OF WATER AND WASTE WATER CUSTOMERS IN SCOTLAND. THE PREVIOUS DAY OUR PREDECESSOR, THE WATER COMMISSIONER, HAD PUBLISHED HIS DRAFT DETERMINATION OF THE LIMITS ON THE PRICES THAT SCOTTISH WATER COULD CHARGE ITS CUSTOMERS DURING THE PERIOD 2006-10.**

The Commission's first task was to consult on the draft determination and to decide the final price limits that we announced on St Andrew's Day. These limits meant that household customers would face price rises of no more than 0.5% below inflation and non-household customers rises of no more than 1.5% below inflation for each of the four years of the final determination.

The final determination was designed to ensure that Scottish Water delivered ministerial objectives on quality and better service to customers economically. It was therefore important that the quality regulators, the Drinking Water Quality Regulator and the Scottish Environment Protection Agency, the customer representative, Waterwatch Scotland, ourselves and Scottish Water put in place formal arrangements to monitor the company's work over the next four years. This has now been implemented under the chairmanship of the Scottish Executive, supported by a working group led by the Commission.

The legislation under which we operate provides that non-household customers of all sizes and in all areas can obtain their retail services from suppliers other than Scottish Water. The Scottish Executive has said that this radical change in the structure of the water and waste water industry will take effect from 1 April 2008. The change will need to be carefully managed by not only the Commission but also the Scottish Executive and Scottish Water over the next two years in order to provide non-household customers with real choice while ensuring that the necessary changes do not prejudice Scottish Water's ability to service its household customers. Important features of this proposal will be the separation of Scottish Water's retail arm from its wholesale business to enable competition to be transparent and the introduction of a licensing regime.

Our final determination was good news for customers, with bills for most household and non-household customers rising below the rate of inflation for the next four years.

We aim to be open and transparent in our work. We consult widely with stakeholders, ensuring that they are well informed and can contribute their views.

The Commission is a non-departmental public body with statutory responsibilities, acting independently of Ministers. Our style is to be open and co-operative. We will publish consultative papers and information notes, maintain an informative website and listen to all stakeholders. We will work closely with Scottish Water, the Scottish Executive, the quality regulators and Waterwatch Scotland.

The Commission was fortunate to take over a high-quality office built up by the former Commissioner. We believe that we have had a successful first year and are playing our part in delivering the high-quality water services that the Scottish people deserve.

I would like to take this opportunity to thank all those on the Commission and all those in the office for their dedication and hard work. It is a real pleasure to be a member of such an excellent team.

A handwritten signature in black ink that reads "Ian Byatt". The signature is written in a cursive style with a large, prominent 'I' and 'B'.

SIR IAN BYATT
CHAIRMAN

AN IMPORTANT YEAR

CHIEF EXECUTIVE'S REVIEW



The final determination of charges represented the culmination of a two-year process. We had input from many stakeholders, conducted detailed consultations and arranged workshops and stakeholder information days.

□ **THIS HAS BEEN AN IMPORTANT YEAR FOR WATER AND SEWERAGE CUSTOMERS IN SCOTLAND. IN NOVEMBER WE ANNOUNCED OUR FINAL DETERMINATION OF PRICE LIMITS FOR THE FOUR YEARS TO 2009-10.**

This signalled good news for customers, with most customers seeing below inflation increases in their charges. We have also instigated discussions about how retail competition, required by the Water Services etc. (Scotland) Act 2005, might be implemented. Competition should bring lower prices and better service. This has been an important year too for public health and the environment; our determination will fund one of the largest capital programmes ever seen in the UK. And, in what is a notable new development in Scotland, money has been committed to tackle the problem of leakage from the water distribution system.

This has also been a significant year for this office. Staff now work to support the Commission, with its remit to decide the appropriate level of charges, rather than simply to advise Ministers on the matter.

Scottish Water has the right to appeal such decisions to the Competition Commission. This arrangement should reassure customers and other stakeholders that charges have been set at the minimum reasonable level.

□ **OUR FINAL DETERMINATION**

Our final determination marked the end of the two-year Strategic Review process. We took full account of Ministers' objectives for the water industry, allowing sufficient funding for Scottish Water to deliver not only 'essential' but also 'desirable' objectives. We took full account of the ministerial principles of charging, namely that charges for customers should be stable and harmonised (so that customers in the same group pay for the same service, regardless of their location or of the actual cost of serving them as individuals). Ministers also wished to ensure that Scottish Water should be financially sustainable in the longer term.

The final determination developed the framework of incentive-based regulation that has been applied in private sector utilities. One of the key challenges was to ensure that we could maintain a tight budgetary constraint in the public sector context. A further challenge was to find ways to encourage outperformance without reducing the pressure to deliver that is created by such a constraint.

The Scottish Executive responded favourably to our arguments, acknowledging both the benefits of an incentive-based approach and the importance of a tight budgetary constraint. It also shared our view that bonus payments to management should be fully self-financing and only made when regulatory expectations have been outperformed. This ensures a clear relationship between personal reward and delivery.

The final challenge was to make sure that when we compared costs incurred by Scottish Water in delivering service we took proper account of the differences in levels of service provided to customers on either side of the border. We achieved this by setting milestones for improvement in Scottish Water's overall customer service performance. We will use these to monitor Scottish Water's progress in closing the gap with the companies in England and Wales.

The final determination recognised the need to address the issue of leakage and provided funds to Scottish Water so that it could take appropriate action to reduce and control the level of network leakage. The determination set out our expectation that specific leakage targets would be agreed with Scottish Water, and we have now agreed initial targets to reduce leakage by a quarter over the next two years, compared with estimated levels in 2004-05. We will monitor and report on performance in this area.

The final determination looks forward to future prices. Even assuming that Scottish Water does not outperform our expectations, it should be possible for bills to remain broadly stable beyond 2010. This assumes, however, that the Executive is prepared to continue to lend at current levels.

We published our final determination on 30 November 2005, and Scottish Water announced on 27 January 2006 that it would not be asking us to refer it to the Competition Commission.

Given the positive outlook for prices, the environment and customer service improvements that are financed in the final determination, and the fact that Scottish Water chose not to exercise its right of appeal to the Competition Commission, we can be confident that the determination has achieved the right balance.

Excessive leakage is unacceptable for customers and for the environment. The final determination allowed funding for Scottish Water to make significant progress in addressing this important issue, and we will monitor progress against leakage reduction targets.

□ PREPARING FOR THE NEXT REVIEW

We expect to publish the next final determination, covering the four-year period from 2010-11 to 2013-14, in November 2009.

The period between reviews has been shorter in Scotland than in England and Wales, with reviews here taking place every four years compared with every five years south of the border. The shorter regulatory control period poses particular challenges, allowing less time for review, consideration and preparation. As a result, we have already started intensive preparatory work, and have established a provisional timetable for activity. This is shown in Table 1.

TABLE 1: PROVISIONAL DATES FOR THE NEXT STRATEGIC REVIEW OF CHARGES

ACTIVITY	PROVISIONAL DATE
Issue a consultation document on our approach to the 2009 review	December 2006
Close of consultation	March 2007
Issue our response to the consultation	May 2007
Issue a consultation on our proposed methodology for the 2009 review	August 2007
Close of consultation	November 2007
Issue our response to the consultation	January 2008
Issue guidance to Scottish Water (and any new entrants) for the first draft business plan(s)	March 2008
First draft business plan(s) due to be submitted to us	July 2008
Issue guidance to Scottish Water (and any new entrants) for the second draft business plan(s)	November 2008
Second draft business plan(s) due to be submitted to us	March 2009
Draft determination published	June 2009
Final determination published	November 2009

□ THE COMPETITION FRAMEWORK

The Scottish Executive has recognised that it may be beneficial to introduce some competition into the water industry in Scotland, specifically to non-household customers. Legislation last year established a framework that will allow alternative providers of retail water and sewerage services to non-household customers to enter the market and to compete with a separate entity established by Scottish Water.

The introduction of a competitive market should ensure that Scottish Water's core business is challenged by new retailers to push down its costs and to outperform its regulatory contract. This will benefit all customers – household and non-household.

The market should be opened up to competition by April 2008. Although we have made a good start, much work remains to be done to make sure that market processes and the licensing framework are fully defined and available to potential new entrants.

□ TRANSITION TO THE COMMISSION

The Commission came into existence on 1 July 2005. Clearly our main focus in the first few months was to review the draft determination and responses to it, and to prepare the final determination. Since then we have made considerable progress in establishing an effective working regime. By setting out clear rules of procedure and schedules for regular Commission meetings everybody in the office can contribute their best.

The change to a Commission, with powers to determine charges rather than simply advising on them, places greater responsibilities on our staff. The Commission must be able to rely on analysis of the highest quality from the office, and we have put procedures in place to ensure that these standards are achieved.

□ CONCLUSION

We are committed to providing a cost-effective regulatory service that promotes the needs of customers. The cost of economic regulation is around £1 per connected customer in Scotland. The savings we identified in the final determination amounted to around £1 billion. We constantly review our own expenditure so that we maintain good value. For the next regulatory control period, our budget has been linked to Scottish Water's revenue over the period.

From 1 April 2006, responsibility for handling complaints from customers about water and sewerage services was transferred to Waterwatch Scotland. I very much appreciate its support in facilitating that transfer and look forward to continuing to work with Waterwatch as the independent customer representative.

The progress this office has made during the year would not have been possible without the dedication and enthusiasm of its staff. I would like to thank them for their commitment during what has been a most exciting, eventful and challenging year.



ALAN D A SUTHERLAND
CHIEF EXECUTIVE

KEY MESSAGES

STRATEGIC REVIEW OF CHARGES

2006-10

The following key messages were presented in the final determination of the Strategic Review of Charges 2006-10. The full determination is available on our website at www.watercommission.co.uk

OUR APPROACH

- In setting charges, we have established our view of the lowest reasonable overall cost to deliver the ministerial objectives.
- We believe that a determined management can deliver all of the ministerial objectives for the water industry within the financial framework set by these charge caps.
- Outperformance of this financial framework could reduce customers' charges in future regulatory control periods.

IMPACT ON CUSTOMERS' BILLS

- Most households will see their bills increase by less than the national rate of inflation in each year for the next four years.
- Average household bills are likely to be the third lowest in the UK in 2009-10.
- Most non-household bills will increase by 1.5% less than the rate of inflation in each of the next four years – a total reduction of over 6% in real terms.
- In line with Ministers' principles of charging, we:
 - included a new 25% discount for recipients of Council Tax benefit;
 - allowed for the abolition of the discount on second homes; and
 - unwound £44 million of cross-subsidy from non-household to household customers.
- On present information, charges in the 2010-14 regulatory control period could remain broadly stable in real terms.

BENEFITS TO CUSTOMERS AND TO SCOTLAND

- Our charge caps should allow Scottish Water to:
 - deliver all the 'essential' and 'desirable' ministerial objectives;
 - improve the level of service it provides to customers;
 - reduce leakage significantly, in due course reaching its economic level; and
 - release development constraints across Scotland, enabling provision of 15,000 more homes a year and commercial development that in total would cover an area the size of central Edinburgh.

SCOTTISH WATER'S RESPONSIBILITIES AND OPPORTUNITIES

- The total capital programme allowed for in these price limits for 2006-10 is £2.15 billion (in 2003-04 prices).
- Scottish Water is tasked with delivering a large capital programme; the bigger companies south of the border have successfully delivered programmes of a similar size and with similar efficiencies.
- The price limits allow for Scottish Water's operating costs to increase by 8.4% above the rate of inflation over the regulatory control period.
- Scottish Water's charge limits are based on its much reduced declared customer base. It has an incentive to increase its revenue base.
- If it performs in line with the final determination, Scottish Water will improve its financial strength.

MANAGEMENT OF THE CAPITAL INVESTMENT PROGRAMME

- We believe that Scottish Water should make significant progress in measuring the performance of its assets.
- We have allowed for sufficient operating costs so that Scottish Water should not feel obliged to adopt expensive capital solutions in order to meet outcomes.
- Our review of Scottish Water's proposed capital investment programme has identified evidence of very high unit costs and excessive scope.
- We have growing concerns about the nature of the responsibilities that Scottish Water has delegated to Scottish Water Solutions. Scottish Water should consider how best to improve the efficiency of its capital expenditure.

GOVERNANCE AND INCENTIVES

- We welcome the Scottish Executive's representations on the Commissioner's draft determination. It plans to:
 - link managerial bonuses to outperformance of the regulatory contract (ie to improved value for money to customers);
 - allow Scottish Water to retain additional savings in a financial buffer that will protect customers from the full effects of any operational shocks; and
 - create a borrowing reserve to meet unexpected costs that are outside the control of management.

COMPARISON WITH ENGLAND AND WALES

- Charges in Scotland will increase by less than those in England and Wales between 2006 and 2010.
- Scotland can afford a large investment programme with lower increases in charges because:
 - Scottish Water looks likely to have achieved its regulatory target on operating cost efficiencies in its first four years;
 - there remains further scope for Scottish Water to improve its efficiency; and
 - Scottish Water can borrow from government at lower than general market rates.

AREAS OF ACTIVITY
2005-06

BEST VALUE

ENSURING THAT SCOTTISH WATER DELIVERS FOR CUSTOMERS

In 2009-10, average household bills will be the third lowest in the UK.

- **THE MAIN FOCUS OF OUR WORK THIS YEAR WAS THE PRICE REVIEW. THIS WAS THE CONCLUSION OF A DEMANDING TWO-YEAR PROCESS.**

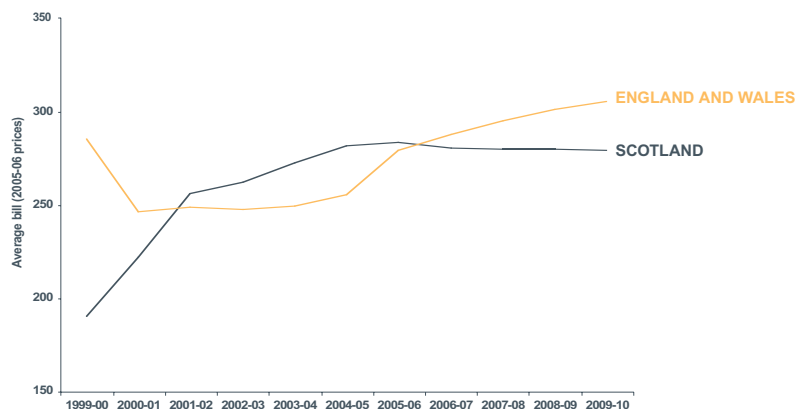
Our aim at the review was to set price limits that provide best value to customers now and in the future. We are now monitoring Scottish Water's progress in delivering the outputs and efficiencies we expect from it.

- **THE 2005 STRATEGIC REVIEW OF CHARGES**

We exist to look after the interests of water and sewerage customers. Last November, we announced the prices that customers will pay for their water and sewerage services for the four years to 2009-10. It was good news for customers, with bills for most households increasing at 0.5% below inflation and bills for non-household customers rising by 1.5% less than the rate of inflation.

Although prices increased sharply in Scotland around the turn of the century to overtake those in England and Wales, they are now set to rise by less than in England and Wales, as Figure 1 shows.

FIGURE 1: AVERAGE HOUSEHOLD BILLS IN SCOTLAND AND IN ENGLAND AND WALES 1999-00 TO 2009-10 (PROJECTED) (2005-06 PRICES)



These prices will still enable one of the largest investment programmes – £2.15 billion (at 2003-04 prices) – ever undertaken in the water industry in Britain.

This investment will bring better drinking water quality, improved environmental performance and enhanced customer service, and will relieve development constraints. It will also allow Scottish Water to make significant progress in tackling leakage.

This good news for customers is the result of more than two years of rigorous effort by this office, and extensive input from Scottish Water, the quality regulators and other stakeholders.

During the review, we set out to operate a transparent process, consulting extensively on the proposed approach and on the Commissioner's draft determination. We also provided regular opportunities for stakeholders to be involved in the price setting process through workshops, presentations and information days.

□ OUR ROLE IN SETTING PRICES

Scottish Ministers provided clear guidance concerning the objectives they wished to see for improvements in water quality, environmental performance and customer service in the Scottish water industry. The guidance distinguished between 'essential' and 'desirable' objectives.

The price limits we set were such that Scottish Water can meet all of these objectives at the lowest reasonable overall cost.

We determined the price limits by assessing the cost to meet the ministerial objectives and by providing a framework for incentives that would encourage Scottish Water to outperform.

Our final determination was the culmination of a detailed and staged approach. It took account of the Commissioner's analysis of Scottish Water's second draft business plan, the draft determination, representations from stakeholders on the draft, and new information.

Evaluating Scottish Water's business plan

Scottish Water's second draft business plan was submitted to the Commissioner's office in April 2005. The plan set out how Scottish Water proposed to meet the ministerial objectives, the resources it would need and the prices customers would pay as a result.

The plan contended that meeting the 'essential' objectives alone would require significant capital investment of £3.3 billion over four years. This would have meant an 88% real increase in charges for customers.

The Commissioner analysed the plan very carefully, and took account of the detailed views of the independent Reporter and independent consultants Faber Maunsell. Ofwat, the water regulator in England and Wales, also helped to benchmark capital costs and review Scottish Water's proposals for maintaining its assets.

The Commissioner compared Scottish Water's performance with its peers in terms of investment costs, operating costs, customer service and financial sustainability. He determined that Scottish Water's plan contained excessive costs, particularly on investment, where there was evidence of over-scoping, duplication of projects and high unit costs. In addition, there was significant scope for Scottish Water to deliver better services to customers and to do so more efficiently.

The draft determination

The Commissioner's draft determination was published in June 2005. He assessed that £2.1 billion investment was required to meet the Ministers' objectives. He also set out his expectations on efficiency and improvements in services to customers.

In its response to the draft determination, Scottish Water argued that "grossly insufficient funding" had been allowed to meet the Ministers' objectives.

□ OUR FINAL DETERMINATION

Between July and November 2005, we reviewed in detail the draft determination and representations from Scottish Water and other stakeholders.

The Scottish Executive's representations were particularly helpful. They paved the way for an effective regime of incentives to encourage good performance by Scottish Water, for example by linking managerial bonuses to outperformance of the regulatory contract.

We established our view of the lowest reasonable overall cost of delivering the ministerial objectives. We considered that levels of service to customers should improve significantly and that high leakage needed to be tackled.

We broadly endorsed the capital programme allowed for in the draft determination but allowed for additional operating expenditure to deliver Ministers' objectives and improvements in customer service.

□ DEVELOPMENTS SINCE THE FINAL DETERMINATION

In late January this year, Scottish Water confirmed that it accepted the outcome of the final determination, and would not be referring the outcome to the Competition Commission.

Ministers then asked Scottish Water to produce a delivery plan setting out how it would meet the requirements of the ministerial objectives and the final determination. Scottish Water produced this delivery plan in early February. Along with the quality regulators, we commented on the extent to which the delivery plan complied with the requirements set for Scottish Water for 2006-10.

We concluded that the plan fell short of these requirements. Scottish Water has now redrafted the delivery plan and submitted it to Ministers.

□ **THE FOCUS OF OUR WORK IN 2006-07**

A key element of our work going forward will be to monitor rigorously Scottish Water's delivery of the final determination. We will monitor performance on operating costs and levels of service to customers, and progress on leakage and metering. We plan to publish reports on Scottish Water's investment and asset management and on its costs and performance in October 2006.

We expect Scottish Water to tackle leakage effectively and pro-actively. We have agreed a target to reduce leakage by a quarter over the next two years, compared with levels of leakage in 2004-05. We will monitor performance closely against this target. We will also work with Scottish Water to determine the optimum economic level of leakage – the point at which the cost of tackling leakage is greater than the cost of the lost water. We expect Scottish Water to reduce leakage to this economic level by 2014.

We will also be working with the Scottish Executive, Scottish Water, the quality regulators and Waterwatch Scotland to monitor Scottish Water's delivery of the required improvements to drinking water quality, environmental performance and the release of development constraints.

The price limits we set will enable Scottish Water to carry out one of the largest investment programmes ever undertaken in the water industry in Britain. This includes investment to address the issue of leakage and meet the leakage targets we agreed.

COMPETITION AND ACCESS

INTRODUCING A NEW LICENSING FRAMEWORK FOR RETAILERS

The new licensing framework should bring direct benefits for non-household customers, offering them a choice of supplier for the first time. We expect that the new framework will also help improve Scottish Water's efficiency and, as such, household customers will also benefit.

□ COMPETITION CAN PROVIDE WIDER CHOICE, LOWER PRICES, BETTER SERVICES AND INCREASED INNOVATION.

This year, new legislation established a legal framework for retail competition in the water industry in Scotland for non-household customers. We have a role in facilitating the introduction of competition. We issued two consultations on the proposed approach.

□ THE IMPACT OF COMPETITION

The way the water industry is organised in Scotland is changing. The Water Services etc. (Scotland) Act 2005 provides a new framework for the industry north of the border. Competition will be limited to retail services to non-household customers, and Scottish Water will continue to provide retail services to households.

Under the Act, and subject to commencement by the Scottish Executive, all retail water and sewerage service providers are to be licensed. This includes the retail entity to be established by Scottish Water ('Scottish Water Business Stream').

Scottish Water is required to establish a demonstrably separate undertaking to deliver the retail elements of water and sewerage service provision to non-household customers.

On average, retail competition should result in lower prices and improved levels of service for non-household customers. Household customers should also benefit because the core activities that Scottish Water undertakes will be more transparent.

Scottish Ministers have said that the market should be opened to new entrants on 1 April 2008. The Commission will exercise its powers under the Act, taking account of both competition law and the decisions of the Competition Commission Appeals Tribunal. In this regard, it should be noted that the Office of Fair Trading would investigate any potential breach of competition law.

□ THE NEW LICENSING REGIME

We are responsible for introducing a licensing framework for retail providers. This includes drafting water and sewerage licences and designing the licence application process. It also includes overseeing the production of industry codes and agreements that will govern the market.

We are responsible for granting licences to Scottish Water Business Stream and, when the market opens, granting licences to other applicants.

□ CONSULTATIONS ON THE APPROACH TO COMPETITION

In April 2005, we published a consultation on the principles of licensing. This explored how competition is developing in Scotland. It also discussed the principles of licensing, drawing on a review of experience in other licensed industries. We received responses from a wide range of stakeholders, and published our conclusions in September. We determined that the retail undertaking created by Scottish Water should be given the opportunity to apply for permanent licences from April 2006.

In November 2005, we issued a further consultation paper which set out our intention that:

- the retail market should be effective, with retailers able to enter and exit the market as appropriate;
- all licensed providers should compete on a level playing field; and
- there should be effective communication between Scottish Water and licensed providers.

We presented draft licence conditions, and began the process of developing the codes and agreements that will govern the retail market. We published our conclusions in March 2006, highlighting our view that in order to protect customers, price and level of service regulation would remain important under the new arrangements. We also concluded that strict ring-fencing arrangements would be necessary to make sure that there is a level playing field between the retail entity created by Scottish Water and new entrants.

In September 2005, we published guidance on the production of a business plan by the retail business created by Scottish Water. This concentrated on making sure that the retail business would provide the information required to demonstrate managerial competence and financial viability.

Scottish Water Business Stream submitted its business plan to us in December 2005. Having reviewed it carefully, we concluded that the business was not yet ready to be granted a permanent licence.

□ THE FOCUS OF OUR WORK IN 2006-07

We plan to publish further guidance on the licence application process, a draft operational agreement and a draft wholesale services agreement in summer 2006. Stakeholders will be given the opportunity to contribute to the development of the various agreements. We intend to publish initial versions of these at the end of 2006.

We believe that the development of the licensing framework should be open and transparent.

We also plan to grant provisional licences to Scottish Water Business Stream. This will depend on it producing a work plan that sets out how governance, separation and financing issues will be addressed.

We have outlined a revised timetable for entrant involvement in the retail market. Entrants will be allowed to apply for licences from January 2007. From April 2007 any entrant who has received a permanent licence will be able to enter pre-agreements with non-household customers to take over provision of retail services from 1 April 2008.

CUSTOMER SERVICE

PROMOTING THE INTERESTS OF CUSTOMERS

Information is critical to effective regulation. It enables us to monitor and compare Scottish Water's performance and to set challenging goals.

- **CUSTOMERS MUST BE CONFIDENT THAT THE SERVICE THEY RECEIVE MEETS THEIR NEEDS AND EXPECTATIONS ON QUALITY AND VALUE FOR MONEY.**

We monitor company performance in providing service to customers, report on performance and set targets for improvement.

- **OUR WORK IN PROMOTING CUSTOMERS' INTERESTS**

We work to promote customers' interests in the following ways:

- We consult with household and non-household customers and other stakeholders about their views and perceptions of the service provided by Scottish Water.
- We provide advice on any factors that should be taken into account by Scottish Water when it fixes charges under its charges scheme.
- We compare the service received by customers in Scotland with that provided elsewhere, identifying any improvements that Scottish Water could make.
- We review Scottish Water's performance against its Guaranteed Minimum Standards (GMS) of service.
- We work with Scottish Water to approve its Code of Practice.
- We set customer service targets for Scottish Water, and monitor performance against these.
- We produce and publish regular Customer Service Reports that review Scottish Water's performance and identify areas for improvement.

We ask for detailed information from Scottish Water through regular information returns and regulatory letters. These requests can be either specific one-off requests or may initiate an additional regular request for information. It is vital that this information is robust and accurate.

The information also enables us to conduct benchmarking exercises against the water and sewerage companies in England and Wales. This benchmarking underpinned Scottish Water's efficiency targets that were set at the Strategic Review of Charges 2002-06 and allowed us to monitor its progress towards those targets during 2005-06. It was also a key part of the process for setting price limits at the Strategic Review of Charges 2006-10.

□ **APPROVING SCOTTISH WATER'S CHARGES SCHEME 2006-07**

Under the Water Industry (Scotland) Act 2002, we are responsible for approving Scottish Water's annual scheme of charges. The scheme of charges lists all of the tariffs that Scottish Water will charge its customers.

The 2006-07 scheme was the first to be approved by the new Commission. It also marked the start of the prices determined by the 2005 Strategic Review.

We approved Scottish Water's scheme of charges for household customers for 2006-07 in January 2006, and those for non-household customers in March 2006. Tariffs for non-household customers are increasing by 1% and tariffs for household customers are increasing by 2%, on average, in 2006-07. This represents below inflation increases in prices for customers. We considered that the scheme of charges was consistent with our final determination.

□ **GUARANTEED MINIMUM STANDARDS**

GMS are minimum standards that Scottish Water must meet, and which customers have a right to expect.

Aspects of service included in the scheme include keeping appointments, responding to complaints, queries and requests, avoiding sewer flooding, and limiting the duration of planned interruptions. The level of compensation is usually £20 although in some instances, such as sewer flooding, larger payments may be made.

The standards are an important element in ensuring that customers receive an appropriate level of service. It is our understanding that at present no payments are made automatically to customers. This places the onus on customers to make a claim when they believe they have suffered a GMS failure.

□ **CUSTOMER SERVICE TARGETS**

At the final determination, we stated that Scottish Water should not seek to live within its charge cap by reducing the level of service it provided to customers. We therefore set milestones to monitor improvements in the level of service provided by Scottish Water each year. These milestones will allow us to confirm that efficiency targets are not being met at the expense of customer service.

We used the overall performance assessment (OPA) framework developed by Ofwat as a basis for these milestones. The OPA depends on a company's performance in 15 individual performance measures including supply interruptions, inadequate pressure and sewer flooding. The milestones are an important way to gauge whether Scottish Water is making good progress in closing the level of service gap with the companies in England and Wales. The OPA milestones are set out in Table 2.

TABLE 2: MILESTONES FOR THE OPA

	2004-05	2006-07	2007-08	2008-09	2009-10
OPA	177	195	213	232	250

We have established milestones for performance that will help us monitor Scottish Water's progress in closing the customer service gap with the companies in England and Wales. Scottish Water is required to narrow the current gap in the level of customer service provided by more than 40%.

This approach allows us to make an objective assessment of improvements in efficiency, taking account of the level of service provided to customers.

In a move that we very much welcomed, the Scottish Executive has also made clear that it intends to link bonus payments for Scottish Water's management with performance in meeting these OPA targets.

□ **THE FOCUS OF OUR WORK IN 2006-07**

Customer Service Report 2003-06

In September 2006, we intend to publish a report examining Scottish Water's performance in meeting its OPA milestones and against the GMS, as well as comparing performance with that of the companies in England and Wales.

Scottish Water's charges scheme 2007-08

Scottish Water should submit its draft scheme of charges for 2007-08 to this office by 30 September 2006. Approval of the charges scheme should take place early in 2007.

COMMUNICATION

BUILDING AN UNDERSTANDING OF OUR WORK

- **WE ARE COMMITTED TO WORKING CLOSELY WITH THE MANY STAKEHOLDERS WITH AN INTEREST IN THE SCOTTISH WATER INDUSTRY. SOUND DECISIONS NEED TO TAKE ACCOUNT OF ALL VIEWPOINTS.**

During preparation of the new price limits, we provided opportunities for individuals and groups to understand the price setting process, ask questions and have their say.

- **STAKEHOLDER INFORMATION DAYS**

In the 18-month period leading up to publication of the final determination in November 2005, we held stakeholder information days every six weeks or so. These meetings provided a key opportunity for stakeholders to engage in and influence the work of the Strategic Review and were a significant element of our consultation process.

We invited a wide range of stakeholders to take part, and published information about the days on our website and in relevant publications.

- **WORKSHOPS**

We held a number of workshops with stakeholders during last year, including two meetings with Scottish Water concerning its draft business plan and special factors.

- **CONSULTATIONS**

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

During the year we consulted on the former Commissioner's draft determination of charges, seeking responses from a wide range of stakeholders and considering these representations carefully in coming to our conclusions in the final determination.

We are also consulting in detail on the way forward for competition and access in the water industry. We published a consultation on general principles relating to competition and access in April 2005, and on the competition regime in November 2005. We held a number of licensing information days during the year to discuss with stakeholders the contents of the licensing documents and the process for the forthcoming consultations.

There will be a further two consultations before the retail market is opened up to new entrants in April 2008.

□ **MSP AND SCOTTISH EXECUTIVE BRIEFINGS**

During the year we provided a full briefing to MSPs on the outcome of the final determination. This session was designed to provide MSPs with an update on our work and to strengthen our lines of communication with Parliament. We are planning to hold further MSP briefings in the forthcoming year, covering a range of issues including development constraints and retail access.

We held a number of briefings at the Scottish Executive in the run up to the draft determination, and after it was published, to explain our approach and the decision-making process. We also held a formal briefing with members of the Executive and the quality regulators in September 2005.

□ **VISITS**

In January 2006 the new Deputy Environment Minister Rhona Brankin MSP visited the office to meet Commission members and staff.

We hosted a number of other visits during the year, including a delegation from the Water and Waste Regulatory Office in Kosovo and a party from the Vietnamese government. During these visits members of staff made presentations to explain key areas of our work.

□ **MEETING OTHER STAKEHOLDERS**

The new Commission has met a number of key stakeholders, including other regulators, to introduce themselves and establish links for the future. Such meetings will continue to be held on a regular basis so that the Commission can explain its work and discuss significant issues with others in the industry.

□ **PUBLICATION LAUNCHES AND PRESS RELEASES**

As part of our commitment to inform stakeholders about the price setting process we held launches for the draft determination in June and for the final determination in November. We presented our key messages and answered questions from the press and other stakeholders. We received wide coverage in the national press and on television.

Stakeholders have the right to be kept informed. We are committed to improving communication so that people understand what we do and are able to contribute to our work.

We issue regular press releases. Subjects this year included publication of Scottish Water's second draft business plan, our open letter to the Minister on the progress of the Strategic Review of Charges 2006-10, and inception of the Commission.

Information notes

We use information notes to inform people of our role and water industry issues. In the coming year, we plan to publish a number of new information notes that will be available on our website and distributed to key stakeholders. They will provide up-to-date information about issues such as development constraints and borrowing.

□ THE COMISTON LECTURES

Since 2003, this office has held an annual lecture known as the 'Comiston Lecture'. The guest speaker at the 2006 lecture, held in March 2006, was the Commission Chairman, Sir Ian Byatt. His presentation was entitled 'Changing the taps: Regulating water in Scotland'.

□ FREEDOM OF INFORMATION ACT

The Freedom of Information (Scotland) Act 2002 came into force on 1 January 2005. The Act gives a general right of access to all types of recorded information held by public authorities, sets out exemptions from that right and places a number of obligations on public authorities. Any person who makes a request to a public authority for information is entitled to receive that information, subject to certain exemptions.

Under section 23 of the Act, we must adopt and maintain a publication scheme setting out the information that is routinely made publicly available. The scheme has to be approved by the Scottish Information Commissioner, who is responsible for enforcing the Act. In addition, we must ensure that the scheme is reviewed periodically.

In the period 1 April 2005 to 31 March 2006 we received 66 enquiries under the Freedom of Information Act. Of these 66 enquiries, 61 were responded to within the 20 working days deadline and 4 were responded to after the deadline. One enquiry was passed on to Scottish Water.

COMPLAINTS

SETTLING CUSTOMER COMPLAINTS AND DISPUTES

Customers are entitled to complain if the service they receive falls short of their expectations. This year, we have pursued complaints and settled disputes.

- **CUSTOMERS WHO RECEIVE POOR SERVICE OR ARE UNHAPPY ABOUT ANY ASPECT OF THE SERVICE PROVIDED TO THEM ARE ENTITLED TO COMPLAIN.**

During the year, we had a statutory duty to investigate any complaints that had not been satisfactorily resolved by Scottish Water's own complaints procedure. Responsibility for complaints passed to Waterwatch Scotland on 1 April 2006.

- **THE COMPLAINTS WE RECEIVED THIS YEAR**

We settled complaints and disputes as part of our role in ensuring that customers receive a good service at a fair price. All of the complaints we received were recorded, investigated and analysed by our full-time complaints officer. In some cases customer complaints could be dealt with by providing information and explanation. In other cases it was necessary to conduct an investigation into the complaint and provide Scottish Water with a recommended course of action.

During 2005-06 we received 792 complaints about Scottish Water. This represents an increase of 17 over the number of complaints received in relation to the previous year (or 2%).

Complaints for the period January to March 2006 were investigated in conjunction with Waterwatch Scotland. This is a new agency that has been created to represent the interests of Scottish Water's household and non-household customers. One of its key roles is to handle customer complaints. There has been a three-month handover period between the two organisations. From 1 April 2006 we were no longer responsible for dealing with complaints from customers as responsibility from then was formally handed over to Waterwatch Scotland.

Tables 3 to 5 provide a breakdown of this year's complaints by quarter, customer type and subject.

TABLE 3: NUMBER OF CUSTOMER COMPLAINTS BY QUARTER

QUARTER	NUMBER OF COMPLAINTS
April 2005 to June 2005	208
July 2005 to September 2005	233
October 2005 to December 2005	166
January 2006 to March 2006	185
TOTAL	792

TABLE 4: NUMBER OF COMPLAINTS BY CUSTOMER TYPE

CUSTOMER TYPE	NUMBER OF COMPLAINTS		
	2005-06	2004-05	2003-04
Household	469	299	432
Non-household			
Agricultural	25	29	47
Developers	6	0	8
Commercial	266	426	644
Public bodies	12	10	66
Other	14	11	43
Total non-household	323	476	808
TOTAL	792	775	1,240

TABLE 5: NUMBER OF COMPLAINTS BY SUBJECT

COMPLAINT SUBJECT	NUMBER OF COMPLAINTS		
	2005-06	2004-05	2003-04
Water supply	126	55	122
Water mains and pipes	123	83	87
Water pressure	52	31	50
Sewerage service	88	84	68
Sewers and drains	31	27	28
Billing	171	290	208
Charges	91	90	540
Administration	52	50	66
Other	58	65	71
TOTAL	792	775	1,240

Of the 792 complaints we received, 137 were responded to directly by this office, with the remaining 655 referred to Scottish Water for further investigation and resolution.

OFFICE STRUCTURE

MEETING AN EXPANDING REMIT

We have taken steps so that our office operates in an efficient and effective way, and is able to meet the challenges of our new, wider responsibilities.

- **ON 1 JULY 2005 THE NEW WATER INDUSTRY COMMISSION WAS ESTABLISHED, REPLACING THE OFFICE OF THE WATER INDUSTRY COMMISSIONER FOR SCOTLAND.**

Changes in the organisation and management of the office were necessary during the year to reflect the new regulatory structure.

- **CHANGES TO REFLECT OUR EXPANDED REMIT**

The Water Services etc. (Scotland) 2005 Act transferred the former Commissioner's function of promoting the interests of water customers to the Commission. It also gave us the functions of:

- determining limits on Scottish Water's charges (whereas the Commissioner had been required simply to advise Ministers on these matters); and
- creating and managing the UK's first ever regime for licensing the provision of retail water services to the non-household sector.

These new functions, which are subject to scrutiny by the UK Competition Commission, have increased our workload considerably.

The main focus of our work over the next four years will be to monitor and report on Scottish Water's performance against the final determination, to plan for and deliver the next Strategic Review, and to design and implement the framework for retail competition and access.

When we were preparing the final determination last November, we became aware that the office was relying on a small number of key staff to complete what was a highly technical exercise with critical deadlines. We concluded that the structure and composition of the office should be strengthened so that we would be in a robust position to undertake our new, expanded remit. We decided to restructure the office and to revise the terms and conditions for staff so that we would be able to recruit and retain staff of the right calibre in an effective and economical way.

The Scottish Executive recognised the weight of our workload and the need for us to plan delivery of that workload over the four years of the regulatory control period. It agreed our corporate plan and budget for the full period. That agreement recognised that we would need to bring forward proposals for restructuring the office. The Executive required us to implement and operate the restructuring within the limits set for the staff budget element of the budget as a whole. We have complied with that requirement.

The Commission requires significant additional support from the office. Last July, the Director of Corporate Affairs and Customer Service was appointed as Secretary to the Commission. The Secretary is responsible for managing the monthly Commission meetings and for overseeing the wide range of papers that are presented at those meetings. Minutes of the meetings are available on our website.

□ STAFF RECRUITMENT

We recruited two new permanent members of staff during the year; an office junior who undertakes general office duties, and a finance administrator who deals with all finance functions and general office duties as required. These roles were part of the office support needs identified during the restructuring process.

During the year, we recruited two interns from the London Business School MBA programme. Their expertise was especially useful during preparation of the final determination. We intend to recruit further interns during 2006-07.

□ STAFF APPRAISAL AND TRAINING

We have established a working group to produce a performance appraisal procedure that will enable the Remuneration Committee and the Chief Executive to administer a transparent, simple and equitable staff development and bonus system.

The system that the working group produced was approved by the Remuneration Committee and will be implemented during the coming year. This system will also be used to identify training needs among staff and to help develop the organisation.

□ DEVELOPING OUR IT SYSTEMS

A number of IT projects were undertaken during 2005-06. IT staff provided support for the office refurbishment project to accommodate the new Commission. This included new voice, data and power installations and the management of our website and email name changes.

We also upgraded our entire telecommunications infrastructure to ensure that it is robust and sustainable. We introduced Secure Remote Access to our email systems, and upgraded our internet connection so that it provides greater security, efficiency and capacity. Our website was migrated to a newly created dedicated web server.

We introduced a dynamic web-based news service so that staff receive appropriate news updates on current issues in the water industry.

During the coming year we will continue to monitor and improve our systems to ensure that our contingency plans are robust. We shall also be updating our website to reflect our new responsibilities and structure and to conform to appropriate web standards, such as W3C, the Disability Discrimination Act, and eAccessibility in the public sector. We will also be looking to further increase the security and robustness of our regulatory information.

□ **COMMITTEES**

In order to strengthen the governance of the Commission, Audit and Remuneration Committees were both set up in the course of the year. The committees and their advisers provide independent advice to the Commission on the financial management and governance of the office and the remuneration of the Chief Executive and Directors.

GOING FORWARD

BUILDING ON OUR PROGRESS

We have started preparing for the next Strategic Review. We will issue a consultation document on our approach in December 2006, and encourage all stakeholders to express their views.

- **OUR WORK FALLS INTO THREE MAIN AREAS: DETERMINING CHARGES; MONITORING SCOTTISH WATER'S PERFORMANCE; AND ESTABLISHING AND MANAGING A LICENSING FRAMEWORK. THIS YEAR, WE SHALL ALSO BE FOCUSING IN PARTICULAR ON THE ISSUE OF LEAKAGE.**
- **DETERMINING CHARGES**

The determination of charges for the regulatory control period from 2010 will be published towards the end of 2009. However, preparatory work for this review will begin during 2006. The provisional timetable for activity is shown in Table 6.

TABLE 6: PROVISIONAL DATES FOR THE NEXT STRATEGIC REVIEW OF CHARGES

ACTIVITY	PROVISIONAL DATE
Issue a consultation document on our approach to the 2009 review	December 2006
Close of consultation	March 2007
Issue our response to the consultation	May 2007
Issue a consultation on our proposed methodology for the 2009 review	August 2007
Close of consultation	November 2007
Issue our response to the consultation	January 2008
Issue guidance to Scottish Water (and any new entrants) for the first draft business plan(s)	March 2008
First draft business plan(s) due to be submitted to us	July 2008
Issue guidance to Scottish Water (and any new entrants) for the second draft business plan(s)	November 2008
Second draft business plan(s) due to be submitted to us	March 2009
Draft determination published	June 2009
Final determination published	November 2009

□ **MONITORING SCOTTISH WATER'S PERFORMANCE**

Our second principal area of activity relates to detailed monitoring of Scottish Water's performance. This monitoring is based on information that we receive from Scottish Water, including:

- monthly financial information;
- quarterly reports on delivery of the investment programme;
- six-monthly reports on the customer revenue base;
- the annual regulatory return; and
- information that is provided by Scottish Water in response to ad hoc requests.

We will set out our assessment of Scottish Water's performance in a series of regular reports:

- a Costs and Performance Report;
- an Investment and Asset Management Report; and
- a Customer Service Report.

□ **ESTABLISHING AND MANAGING A LICENSING FRAMEWORK**

The Water Services etc. (Scotland) Act 2005 requires us to establish a licensing framework to secure the participation of new entrants to the market for retailing water and sewerage services to non-household customers in an orderly way.

The proposed key dates for the licensing framework to be established are shown in Table 7.

TABLE 7: PROVISIONAL DATES FOR LICENSING FRAMEWORK

ACTIVITY	PROVISIONAL DATE
Licensing Framework Implementation Group begins	May 2006
Third consultation on application pack begins	June 2006
Final application pack published	September 2006
Applications from entrants received	January 2007
Pre-contracts	April 2007
Market opens	April 2008

It is envisaged that we will continue to regulate retail charges throughout the 2006-10 regulatory control period. This will be achieved by means of a licence condition. At the current time, we intend to begin the process of considering the appropriate level for retail charge caps for the period after 2010 in parallel with our provisional work plan for the Strategic Review.

□ **LEAKAGE**

An additional focus of our work this year will be to introduce leakage targets for Scottish Water. We expect Scottish Water to tackle its high level of leakage in a proactive way and have agreed initial targets to reduce leakage by a quarter over the next two years, compared with estimated levels in 2004-05.

We are also working with Scottish Water and industry experts to promote best practice in estimating leakage across Scotland, and to identify, by December 2007, the optimum economic level of leakage. This is the level where the cost of mending leaks equals the cost of the lost water. Reducing leakage to its economic optimum level is clearly in the interests of customers. We expect this goal to be achieved by 2014.

FINANCIAL YEAR 2005-06

PRO FORMA FINANCIAL INFORMATION

Financial information provided in this report is unaudited and subject to external audit by Audit Scotland. The results reflect the fact that income has been recognised on a receipts basis in accordance with the accounting policy of the Commissioner and the Commission.

As a result of differences in timings at March 2006, £152,303 of grant income that was received from the Scottish Executive in April 2006 but which related to pre-March 2006 expenditure was not recognised in the results shown. If this money had been received before 31 March 2006, income for the 12 months would have been £3,847,388 instead of £3,695,085 and the resulting surplus for the period would have been £22,242 instead of the deficit reported opposite.

□ UNAUDITED SUMMARY INCOME AND EXPENDITURE ACCOUNT FOR THE YEAR ENDED 31 MARCH 2006

The following unaudited summary of income and expenditure includes the period 1 April 2005 to 30 June 2005 which was under the responsibility of the Commissioner, together with the period 1 July 2005 to 31 March 2006 which was under the responsibility of the Commission.

INCOME	NOTES	£
Scottish Water statutory contribution		2,093,260
Grant income from Scottish Executive		1,571,264
Other income		30,561
TOTAL INCOME		3,695,085
EXPENDITURE		
Staff remuneration	1	1,287,397
Staff travel and subsistence		62,232
Accommodation		137,363
General operating costs		421,241
Consultancy projects		232,785
Recruitment		1,199
Information project & IT support		36,726
Strategic Review of Charges		702,770
Licensing		881,388
Non-cash costs (eg depreciation)		59,186
Finance charges		2,859
TOTAL EXPENDITURE		3,825,146
NET DEFICIT AT 31 MARCH 2006		(130,061)

□ UNAUDITED BALANCE SHEET AS AT 31 MARCH 2006

	NOTES	31 MARCH 2006 £
FIXED ASSETS		
Tangible assets	2	174,000
CURRENT ASSETS		
Debtors & prepayments		96,552
Cash at bank and in hand		54,850
		151,402
CURRENT LIABILITIES		
Creditors: amounts falling due within one year	3	(207,655)
NET CURRENT LIABILITIES		(56,253)
NET ASSETS EXCLUDING PENSION ASSETS AND LIABILITIES		117,747
Pension assets		863,000
Pension liabilities		(824,000)
NET ASSETS INCLUDING PENSION ASSETS AND LIABILITIES		156,747
CAPITAL AND RESERVES		
General reserve	4	156,747

□ **NOTES TO THE UNAUDITED FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 2006**

1. STAFF

**(INCORPORATING THE WATER INDUSTRY COMMISSIONER FOR SCOTLAND
FROM 1 APRIL 2005 TO 30 JUNE 2005)**

The aggregate cost of remuneration comprises:

	YEAR ENDED 31 MARCH 2006
	£
Employees' remuneration	1,231,219
Remuneration paid on behalf of the Water Customer Consultation Panel deducted from levy payments made to them	(195,451)
Redundancy costs	33,388
	<hr/> 1,069,156
Employer's National Insurance contributions	132,965
Current service costs and amounts payable to defined contribution scheme:	85,276
Amounts included within operating profit	<hr/> 1,287,397

The average number of staff employed in the period by the organisation was 20 (including the Commissioner). Staff were employed in the following areas:

	YEAR ENDED 31 MARCH 2006
Directors, including Commissioner	5
Corporate Affairs	7
Investment and Asset Management	2
Costs and Performance	5
Customer Service and Revenue	1

2. TANGIBLE FIXED ASSETS

	EQUIPMENT	FURNITURE & FITTINGS	TOTAL
	£	£	£
COST			
At 1 April 2005	154,868	180,137	335,005
Additions	16,798	13,211	30,009
Disposals	-	-	-
At 31 March 2006	171,666	193,348	365,014
DEPRECIATION			
At 1 April 2005	69,411	62,418	131,829
Charge for the year	39,711	19,474	59,185
Eliminated on disposals	-	-	-
At 31 March 2006	109,122	81,892	191,014
NET BOOK VALUE AT 31 MARCH 2006	62,544	111,456	174,000

3. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	AS AT 31 MARCH 2006
	£
Trade creditors	147,601
Accruals and other creditors	60,054
	207,655

4. CAPITAL AND RESERVES

Funding is by way of the statutory contribution paid by Scottish Water, as directed by Scottish Ministers:

	GENERAL RESERVE EXCLUDING PENSION RESERVE	PENSION RESERVE	GENERAL RESERVE INCLUDING PENSION RESERVE
	£	£	£
Balance as at 1 April 2005	249,966	-	249,966
Deficit for the year	(136,061)	6,000	(130,061)
Recognition of other recognised gains and losses	3,842	33,000	36,842
Balance as at 31 March 2006	117,747	39,000	156,747

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