

# Costs and performance report 2003-06

## Detailed findings

### Overview

This report provides detailed information about Scottish Water's costs and its performance against efficiency targets

PERFORMANCE

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## Chapter 1: The operating efficiencies Scottish Water was required to deliver

### Introduction

At the Strategic Review of Charges 2002-06 (published in November 2001), the former Water Industry Commissioner for Scotland set targets for Scottish Water to improve its operating cost and capital efficiency. Using quantitative and qualitative analysis, he set efficiency targets that would limit bill increases in the regulatory control period and ensure value for money for customers.

In Chapters 1 and 2 we examine Scottish Water's performance in relation to the operating cost efficiencies; Chapters 3 and 4 consider capital efficiencies.

All numbers in this report are in outturn prices unless otherwise stated.

### The operating cost efficiencies required at the 2002-06 Review

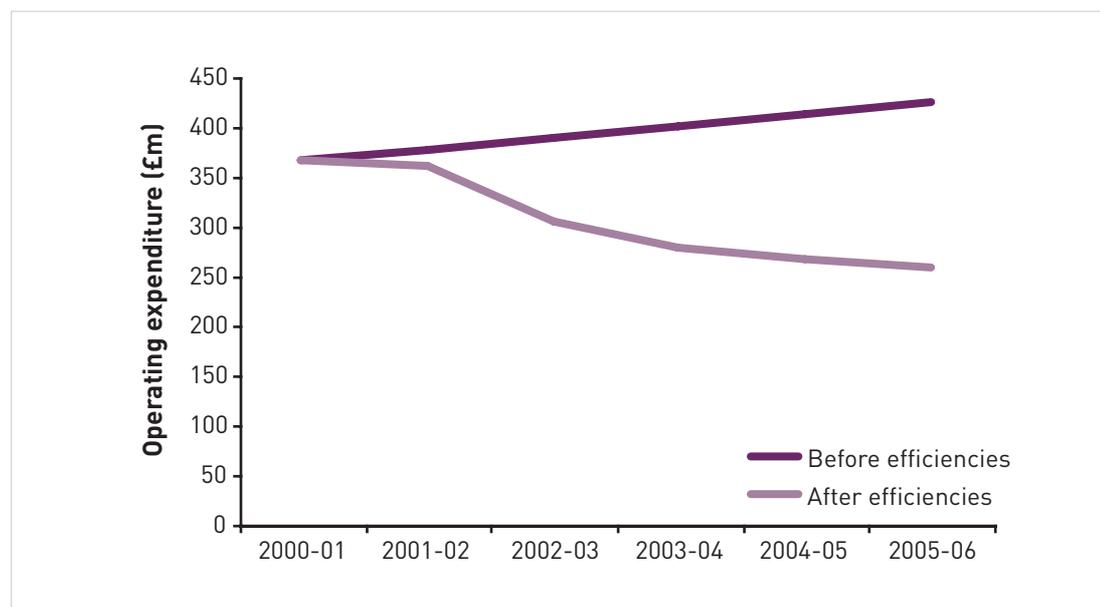
At the 2002-06 Review, the Commissioner established a 'baseline' for the operating costs to run the water and sewerage service in Scotland during the four-year period. He did this by analysing expenditure by function, ie how much it cost to provide a particular service, and by activity, ie the cost of each activity comprising a service. He also allowed for the costs to improve drinking water quality and environmental standards, to meet new demand from customers, and for the effects of annual inflation.

The baseline level of operating cost was the projected cost before taking account of the potential for efficiencies. By comparing the baseline cost with those of the companies in England and Wales, the Commissioner was able to form a view about the scope for efficiency savings, and to set targets accordingly.

The Commissioner drew on detailed information from the water industry in both Scotland and in England and Wales. By comparing the costs of water and sewerage services with information about the assets used, the mix of customers, geographical and other factors that influence cost, it was possible to make objective comparisons of Scottish Water's performance with that of the companies south of the border. Specific adjustments were made to reflect the additional costs of providing services to remote areas and small communities, as well as other costs unique to Scotland. The pace of improvement achieved by companies was also examined in detail. This rigorous approach allowed the Commissioner to set challenging but achievable targets.

Figure 1 shows the projected operating cost expenditure before and after the Commissioner's efficiency targets had been applied. For example, the baseline cost to run the business in 2005-06 was £423 million. Once the efficiency targets had been applied, Scottish Water was required to run its business for £258 million.

Figure 1: Allowed for operating expenditure (before and after efficiency targets)



### Adjustments to the allowed for financing

During the regulatory control period, adjustments were made to update the amount of financing that was available to Scottish Water for operating expenditure. This was as a result of representations from Scottish Water concerning new information that had not been available at the time of the Strategic Review. The adjustments agreed with Scottish Water covered:

- the worse than anticipated starting position that Scottish Water inherited at the start of the review period, with running costs that were higher than the three former water authorities had forecast; and
- new information about Scottish Water’s legal responsibility for sewer laterals<sup>1</sup>.

It was agreed that the final-year operating target would be adjusted by £6.6 million. The adjustments are shown in Table 1.

Table 1: Adjustments that were made to Scottish Water’s allowed for operating expenditure in 2005-06

| Item   | Adjustment          |
|--|---------------------|
| Higher than anticipated starting position on operating costs | £4.0 million        |
| Legal responsibility for sewer laterals                      | £2.0 million        |
| Inflation on these two factors                               | £0.6 million        |
| <b>Total</b>   | <b>£6.6 million</b> |

<sup>1</sup> For further information about these adjustments, please see Volume 2 of ‘Our work in regulating the Scottish water industry’, Water Industry Commissioner for Scotland, August 2004.

Although specific adjustments were not applied for the years 2002-03, 2003-04 and 2004-05, it was recognised that the two factors would affect Scottish Water's ability to achieve the required savings in those years.

### The resulting regulatory contract

The adjusted requirements for operating costs formed the regulatory contract. Table 2 sets out the original baseline costs, the efficiencies set out at the 2002-06 Review, the adjustments made during the four-year control period and the revised regulatory contract. It also highlights the savings that Scottish Water was required to make against the original baseline costs.

**Table 2: The allowed for operating costs (before and after efficiency targets and adjustments)<sup>2</sup>**

|   | 2002-03 | 2003-04 | 2004-05 | 2005-06 | Total   |
|---|---------|---------|---------|---------|---------|
| <b>Baseline costs</b>                                       | £387m   | £399m   | £411m   | £423m   | £1,621m |
| <b>Allowed for costs at the Strategic Review of Charges</b> | £304m   | £277m   | £266m   | £258m   | £1,106m |
| <b>Adjustments</b>  | £0m     | £0m     | £0m     | £7m     | £7m     |
| <b>Revised regulatory contract</b>                          | £304m   | £277m   | £266m   | £265m   | £1,112m |
| <b>Required savings against the baseline</b>                | £83m    | £122m   | £145m   | £158m   | £509m   |

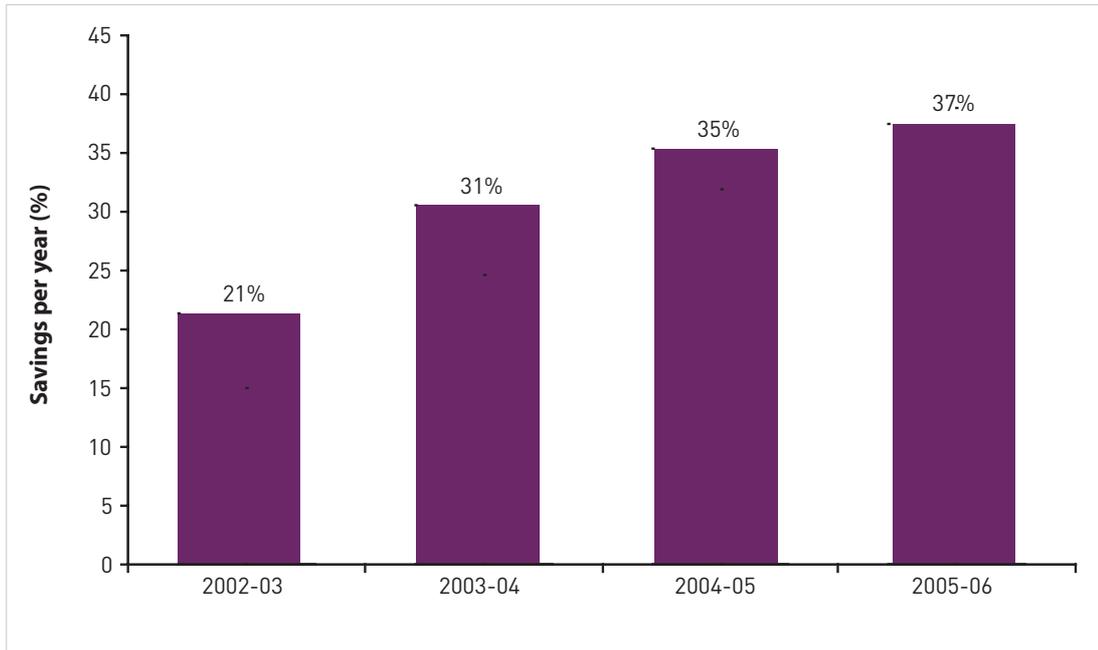
As Table 2 shows, Scottish Water was required to make operating cost savings of £509 million over the four-year period.

### The efficiency improvements required

In terms of its operating cost efficiency, Scottish Water was being set a challenge to improve its efficiency by almost 40% by 2005-06. Figure 2 shows the annual profile of this challenge.

<sup>2</sup> Figures may not add up, due to rounding.

Figure 2: The operating cost efficiency improvements required



Chapter 2 examines how Scottish Water has performed in delivering these operating cost efficiencies.

# CHAPTER 2

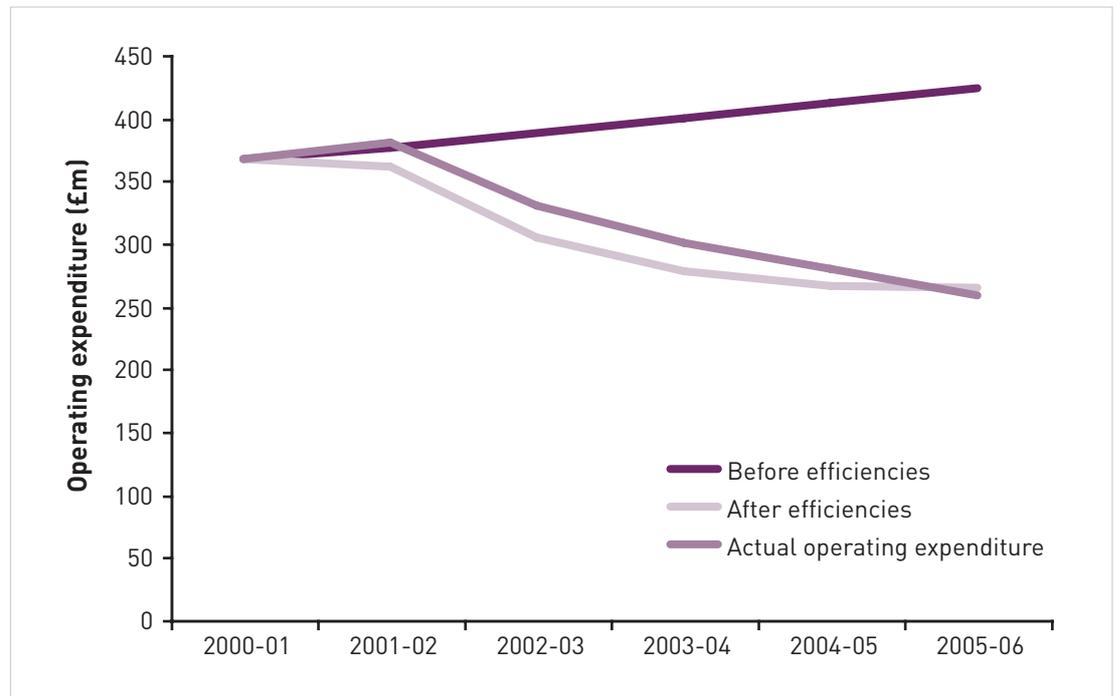
## Chapter 2: How Scottish Water has performed on operating costs

### Performance against targets

The Commission is pleased to report that Scottish Water has become more efficient in running its day-to-day operation, responding well to the targets that were set in 2001.

Figure 3 shows how the actual operating costs compare with the targets that were set at the Strategic Review 2002-06<sup>3</sup>. Scottish Water achieved the operating cost target by the end of the period (ie in 2005-06).

**Figure 3: Target and actual operating expenditure to March 2006**

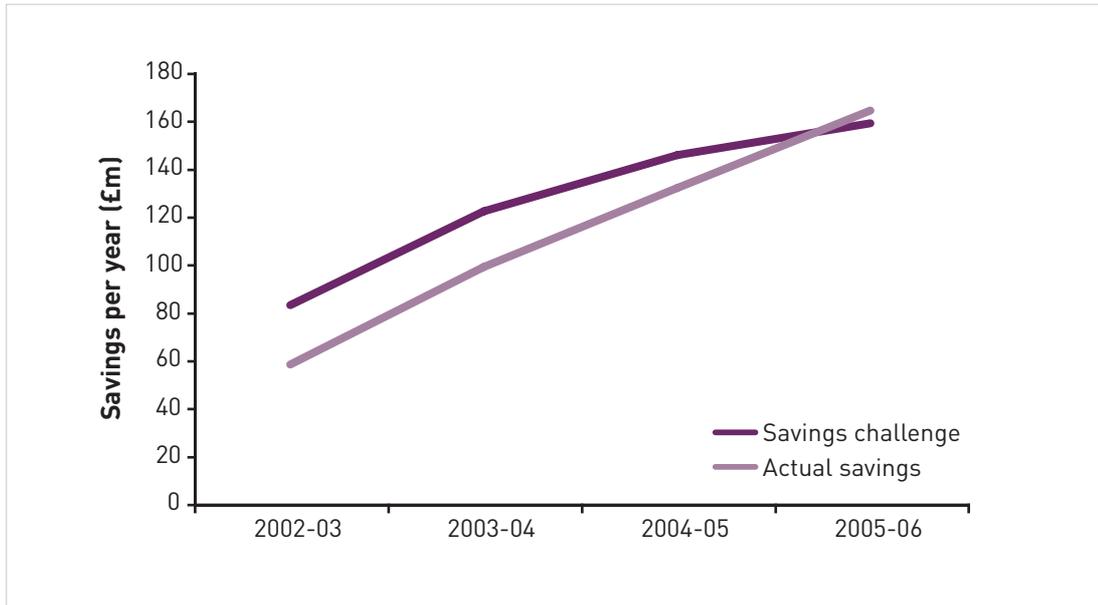


### The savings that Scottish Water has generated

Figure 4 shows the operating cost savings that Scottish Water has made each year. In 2005-06, Scottish Water spent £164 million less a year to run its business – saving more than £3 million a week. Over the four-year period, cumulative savings of £453 million have been generated.

<sup>3</sup> After the adjustment of £6.6 million to the target for 2005-06.

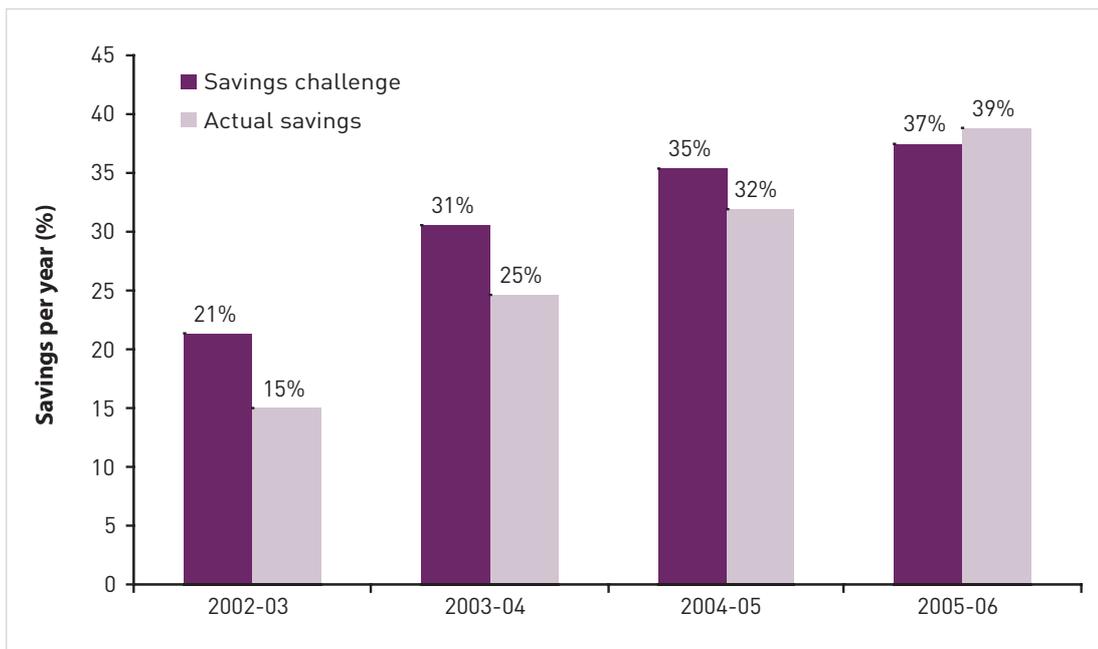
Figure 4: What the actual savings were each year



**The efficiency improvements that Scottish Water has achieved**

Since 2002, Scottish Water has reduced its operating costs by almost 40%. At the same time, it has delivered better drinking water and environmental quality and made improvements in other aspects of customer service. In other words, it has delivered more for less. Figure 5 highlights the efficiency improvements that Scottish Water has delivered over the four-year period.

Figure 5: Operating cost efficiency improvements delivered by Scottish Water



# CHAPTER 3

## Chapter 3: The capital efficiencies Scottish Water was required to deliver

### Introduction

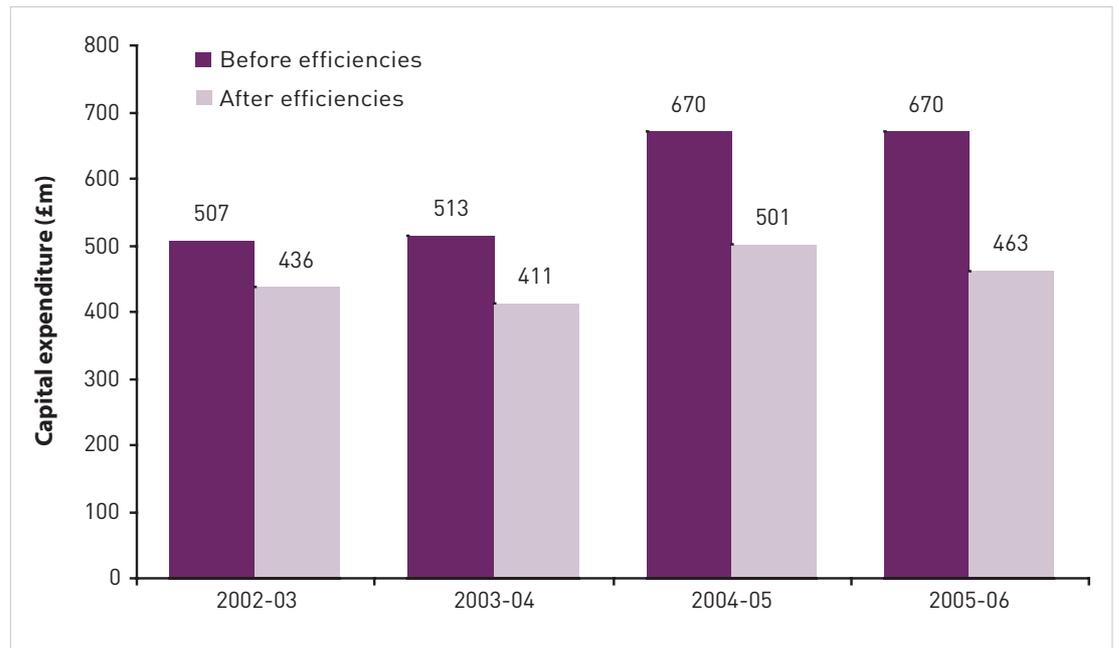
In addition to its day-to-day running costs, Scottish Water undertakes significant expenditure on its capital investment programme. Investing in the water and sewerage assets maintains levels of customer service, improves the quality of service (so that Scottish Water meets higher environmental and quality standards); and ensures that customers' changing demand can be met.

The objectives for this investment are determined by Scottish Ministers and delivered by Scottish Water, through a process called 'Quality and Standards'. Progress is measured against a set of defined outputs which, when fully delivered, will provide higher standards of drinking water, cleaner rivers and beaches, and better service to customers.

### The efficiencies required at the 2002-06 Review

The Quality and Standards 2 investment programme ran from 1 April 2002 to 31 March 2006. At the Strategic Review of Charges 2002-06 the programme was costed at more than £2.3 billion, before taking account of the scope for capital efficiency in delivering the programme. Once the Commissioner's efficiency targets had been applied, Scottish Water was required to deliver the investment outputs for £1.8 billion. Figure 6 shows the projected capital expenditure before and after the Commissioner's efficiency targets had been applied.

**Figure 6: The allowed for capital expenditure (before and after efficiency targets)**



### Adjustments to the allowed for financing

During the regulatory control period, adjustments were made to update the amount of financing available to Scottish Water for capital investment. The adjustments reflected changes associated with higher than expected inflation and the impact on Scottish Water of having to meet additional outputs, including new legislative requirements on health and safety and increased site security. It should be noted that the allowed for adjusted investment was not subject to any efficiency targets. The adjustments to the allowed for financing are shown in Table 3.

**Table 3: Adjustments to Scottish Water's allowed for capital expenditure**

| Item   | Adjustment          |
|--|---------------------|
| Higher than expected inflation                             | £178 million        |
| Additional security requirements                           | £32 million         |
| New legislative requirements relating to health and safety | £40 million         |
| Increased contributions to developers                      | £38 million         |
| <b>Total</b>   | <b>£288 million</b> |

### The resulting regulatory contract

The adjusted requirements for capital costs formed the regulatory contract. Table 4 sets out the baseline costs, the efficiencies set at the 2002-06 Review, the adjustments made during the four-year period and the revised regulatory contract.

Table 4 also highlights the capital expenditure savings that Scottish Water was required to make during the period.

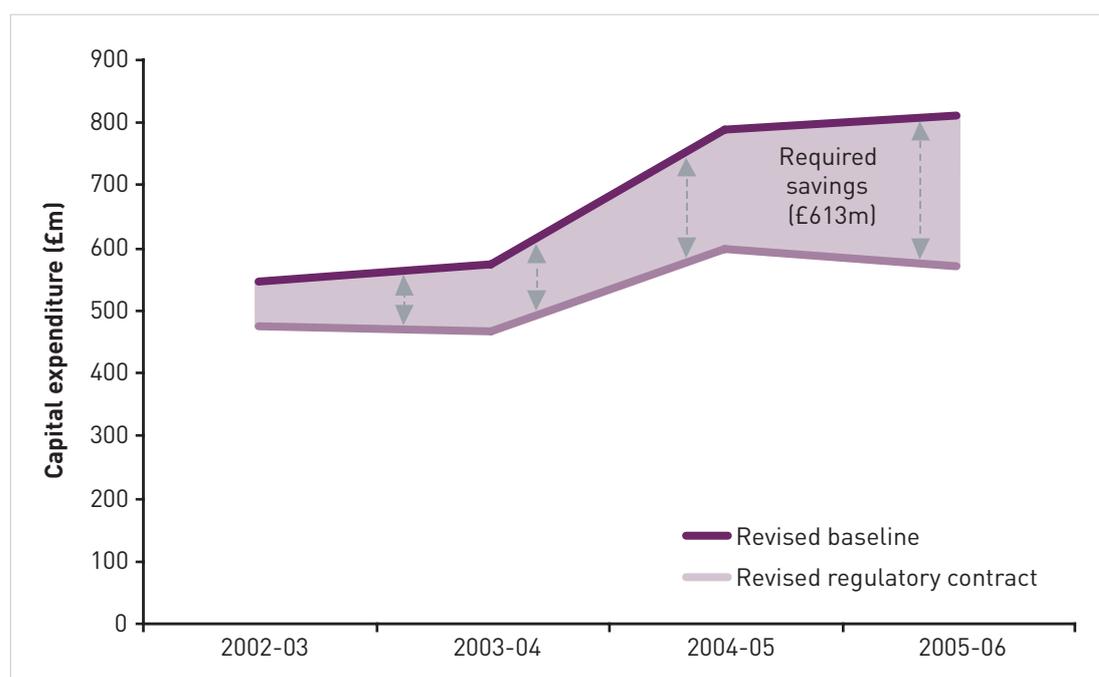
# CHAPTER 3

Table 4: Allowed for capital costs (before and after efficiency targets and adjustments)<sup>4</sup>

|   | 2002-03 | 2003-04 | 2004-05 | 2005-06 | Total   |
|---|---------|---------|---------|---------|---------|
| <b>Baseline costs</b>                                       | £507m   | £513m   | £670m   | £670m   | £2,359m |
| <b>Allowed for costs at the Strategic Review of Charges</b> | £436m   | £411m   | £501m   | £463m   | £1,810m |
| <b>Adjustments to baseline</b>                              | £38m    | £59m    | £116m   | £138m   | £351m   |
| <b>Adjustments to allowed for costs</b>                     | £36m    | £52m    | £95m    | £105m   | £288m   |
| <b>Revised baseline</b>                                     | £545m   | £572m   | £786m   | £808m   | £2,711m |
| <b>Revised regulatory contract</b>                          | £472m   | £463m   | £595m   | £568m   | £2,098m |
| <b>Required savings against the baseline</b>                | £73m    | £109m   | £191m   | £241m   | £613m   |

As Table 4 shows, Scottish Water was required to make capital savings of £613 million over the four-year period. Figure 7 illustrates the annual profile of the required savings.

Figure 7: Capital cost savings required

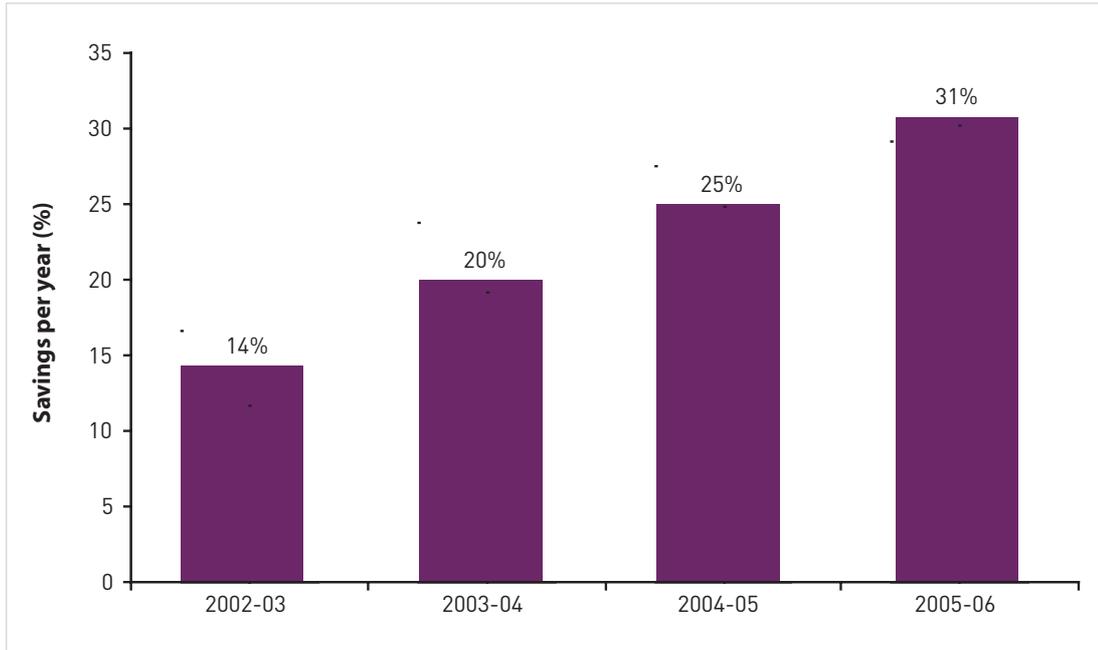


<sup>4</sup> Figures may not add up, due to rounding.

**The efficiency improvements required**

By requiring Scottish Water to make savings of £613 million over the four-year period, it was being set the challenge of improving its efficiency by 31% by 2005-06. The challenge was phased gradually over four years, so would amount to a 24% improvement over the programme as a whole. Figure 8 shows the annual profile of the required efficiencies.

**Figure 8: Capital cost efficiency improvements required**



Chapter 4 examines how Scottish Water has performed in delivering these capital cost efficiencies.

# CHAPTER 4

## Chapter 4: How Scottish Water has performed on capital costs

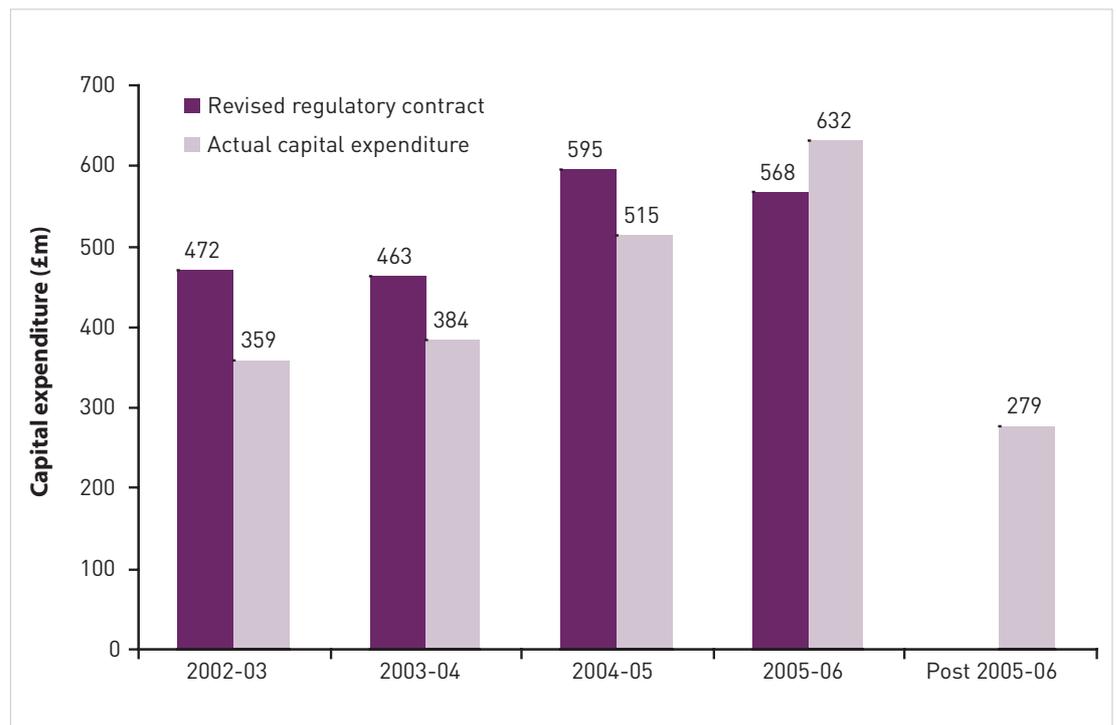
As capital investment projects take place over long timescales, it can be difficult to assess progress in capital cost efficiency on a year-on-year basis. However, it is still possible to gain a broad picture of progress and the likely level of capital cost savings that Scottish Water has achieved over the 2002-06 period.

The Strategic Review of Charges 2002-06 required Scottish Water to deliver £613 million of savings, after adjustments.

### Performance against targets

Figure 9 shows how Scottish Water’s actual capital costs compare with the baseline costs and the targets that were set at the Strategic Review 2002-06.

Figure 9: Capital cost performance against targets



### The savings that Scottish Water has generated

The Commission’s ‘Investment and asset management report’ (published in October 2006) explained that Scottish Water has delivered nearly 90% of the outputs it was required to deliver during the Quality and Standards 2 investment period. However, some of the required outputs met with delays and a large number were still to be delivered by the end of the 2002-06 period. The fact that some outputs remain to be delivered has an impact on our conclusions about the savings that Scottish Water has made in the four-year regulatory control period.

As a result of the delays to some of the capital outputs, an estimated £69 million of savings have been delayed beyond March 2006. An overspend of £51 million has also been identified within the investment programme<sup>5</sup>; this relates to the difference between the revised allowed for capital expenditure (£2,098 million) and Scottish Water’s actual forecast (£2,148 million<sup>6</sup>) to deliver all outputs. This reduces the estimated savings achieved by Scottish Water over 2002-06 to £494 million. In 2005-06 alone, savings of around £5 million a week were achieved. Table 5 summarises the savings that have been made.

**Table 5: Summary of performance 2002-06<sup>7</sup>**

|  |                     |
|--|---------------------|
| Target savings identified in regulatory contract       | £613 million        |
| Less: savings delayed beyond March 2006                | £69 million         |
| Less: overspend in the investment programme            | £51 million         |
| <b>Equals: estimated savings achieved over 2002-06</b> | <b>£494 million</b> |

If the remaining outputs are delivered within the amount that was allowed for in the Commission’s final determination, Scottish Water will have achieved efficiency savings of around £562 million, relative to the baseline costs for delivering the full investment programme outputs that were indicated before any efficiencies. This is illustrated in Figure 10.

**Figure 10: Capital cost savings achieved by Scottish Water**



<sup>5</sup> 'Investment and asset management report 2003-06'.

<sup>6</sup> Excluding customer contributions.

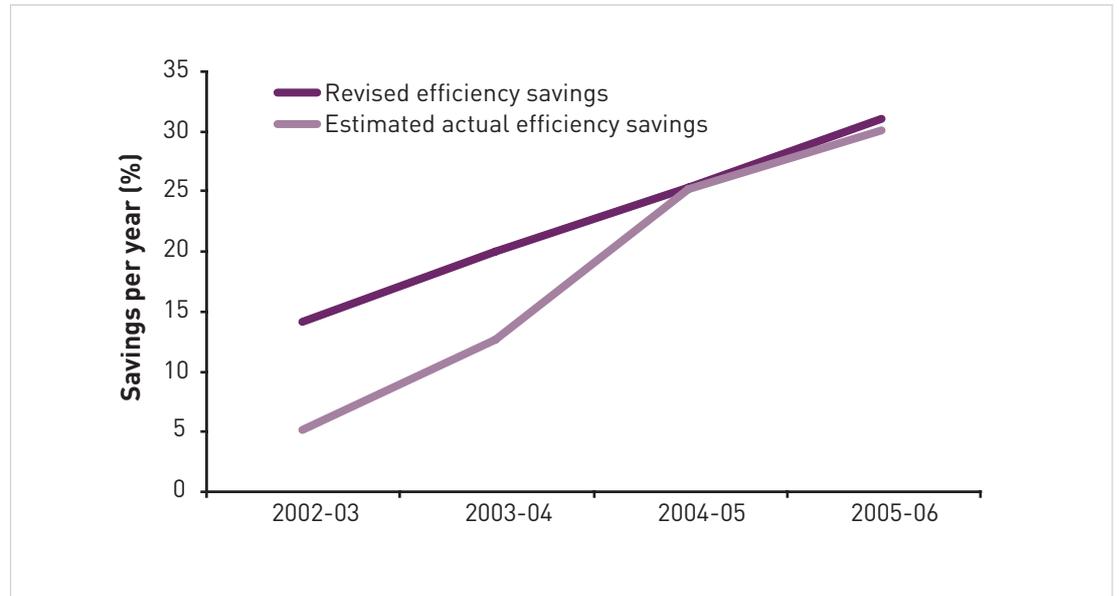
<sup>7</sup> Figures may not add up, due to rounding.

# CHAPTER 4

## The efficiency improvements that Scottish Water has achieved

Over the period 2002-03 to 2005-06 as a whole, Scottish Water has delivered investment outputs 22% more efficiently than the projected baseline. The improvement by 2005-06 is estimated at around 30%<sup>8</sup>. Figure 11 shows the annual profile of improvement in efficient delivery of investment outputs.

**Figure 11: Capital cost efficiency improvements achieved by Scottish Water**



<sup>8</sup> This estimate is based on comparisons of the amount spent on projects completed during the year against their original budget (adjusted for projects with no funding).

## Chapter 5: The impact on customers' bills

### Introduction

At the time of the Strategic Review of Charges 2002-06, there was significant upward pressure on customers' bills. There was a requirement to finance investment to improve water quality, environmental performance and customer service, and to ensure a financially stable water industry in future years.

By setting challenging but realistic targets for Scottish Water to become more efficient, the Commissioner was seeking to keep any necessary increases in customers' bills as small as possible.

### The savings Scottish Water has made

Table 6 summarises the total savings Scottish Water was required to deliver over the four-year period, and the actual savings achieved.

**Table 6: Total required and actual savings 2002-06<sup>9</sup>**

| Area of savings       | Required savings      | Actual savings achieved |
|-----------------------|-----------------------|-------------------------|
| Operating expenditure | £509 million          | £453 million            |
| Capital investment    | £613 million          | £494 million            |
| <b>Total</b>          | <b>£1,122 million</b> | <b>£946 million</b>     |

In 2001, Ministers agreed a specific 'spend to save' allowance of £200 million, financed by customers, to be spent by Scottish Water on initiatives that would reduce its costs going forward and help it to achieve the efficiency targets.

After taking account of the spend to save allowance, the overall savings to customers from the operating cost and capital efficiencies that Scottish Water has achieved in the past four years is estimated at £746 million. The cost reductions that Scottish Water has made are higher than have been delivered by any other water company in the UK in a four-year period, in both millions of pounds and percentage terms.

### Keeping customers' bills down

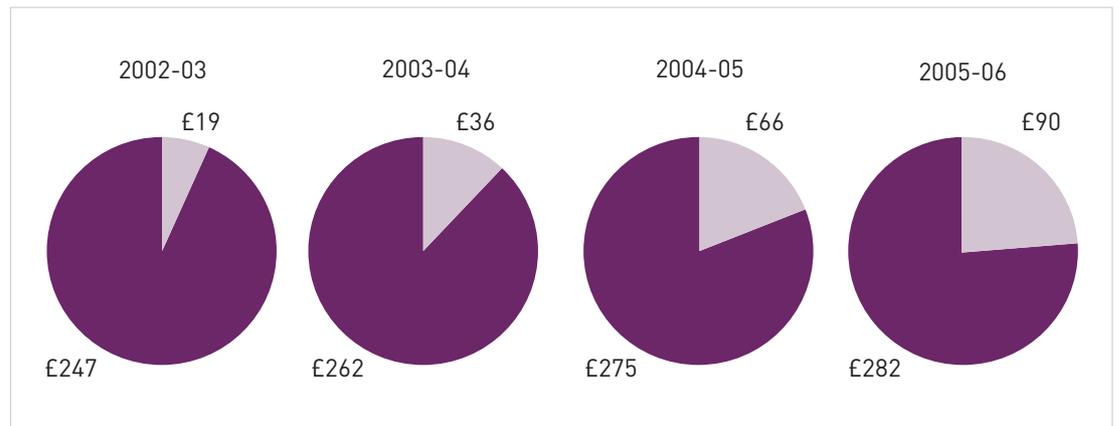
The large savings generated by Scottish Water through effective regulation bring direct benefits to customers, by reducing the requirement for revenue from customers.

<sup>9</sup> Figures may not add up, due to rounding.

CHAPTER 5

As a direct result of Scottish Water’s improved efficiency, customers’ bills are £90 a year lower than they would otherwise have been. Average household bills in 2005-06 were £282 a year, not £372 (which is the level they would have been if Scottish Water had not been set efficiency targets). Figure 12 shows how much customers have saved on their bills for each year of the regulatory control period.

Figure 12: How much customers have saved on their bills<sup>10</sup>



Business customers in Scotland have also benefited from lower bills. For example, bills for a typical newsagents or grocers were kept around £90, or around 25%, lower last year than they would otherwise have been. Larger businesses have enjoyed similar percentage savings on their bills.

**How bills compare with other utilities in Scotland**

As a result of the efficiencies that Scottish Water has made, household water and sewerage bills now compare well with other utilities in Scotland, as Table 7 illustrates.

Table 7: Comparison of average utility bills in Scotland<sup>11</sup>

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

<sup>10</sup>Figures for savings are shown gross of 'spend to save'.

<sup>11</sup>Source for average electricity and gas bills is the Department of Trade and Industry, quarterly energy prices.

## Chapter 6: Looking forward – the efficiency challenge

### The scope for further efficiencies

The Commission welcomes the substantial improvement in Scottish Water's performance over the past four years. The framework of regulatory targets, combined with determined management, is generating real benefits for customers. Scottish Water's efficiency improvements mean that it is catching up with the companies south of the border.

If we consider the value for money that customers in Scotland are receiving relative to that which is experienced by customers south of the border, however, there is still scope for further efficiencies. For example, for every pound Scottish Water spent in 2004-05 in providing a service to customers, the leading company in England and Wales spent only 75 pence to provide the same service.

At the Strategic Review of Charges 2006-10, the Commission examined Scottish Water's performance relative to that of its peers in England and Wales in detail, and took full account of factors affecting costs in Scotland. The Commission has since updated this benchmarking with new information. The analysis reveals that there is still scope for Scottish Water to improve its operating cost and capital efficiency by around 25% from 2004-05 levels. The challenge going forward will be for Scottish Water to improve performance so that it can close these gaps.

Table 8 summarises the latest benchmarking results, showing the efficiency gaps between Scottish Water and the leading company for each category of cost<sup>12,13</sup>.

**Table 8: Benchmarking results**

|   |     |
|---|-----|
| Water service operating cost efficiency gap <sup>14</sup> | 25% |
| Sewerage service operating cost efficiency gap            | 25% |
| Capital expenditure efficiency gap <sup>15</sup>          | 24% |

<sup>12</sup>For further details about the capital cost benchmarking, see 'The Strategic Review of Charges 2006-10: The draft determination', Volume 5, Chapters 7 and 14. For capital cost benchmarking results for the final determination, see 'The Strategic Review of Charges 2006-10: The final determination', Chapter 17.

<sup>13</sup>For further details about the operating cost benchmarking models see 'The Strategic Review of Charges 2006-10: The draft determination', Volume 6, Chapters 8-10. For details of the adjustments for Scotland see *ibid*, Chapters 11 and 12. For operating cost benchmarking results for the final determination, see 'The Strategic Review of Charges 2006-10', Section 3, Chapter 11.

<sup>14</sup>Operating cost efficiency gaps for 2004-05 are based on Ofwat's econometric models adjusted for Scottish Water data.

<sup>15</sup>Capital cost efficiency gap for 2003-04, using Ofwat's cost base model.

# CHAPTER 6

## Future monitoring

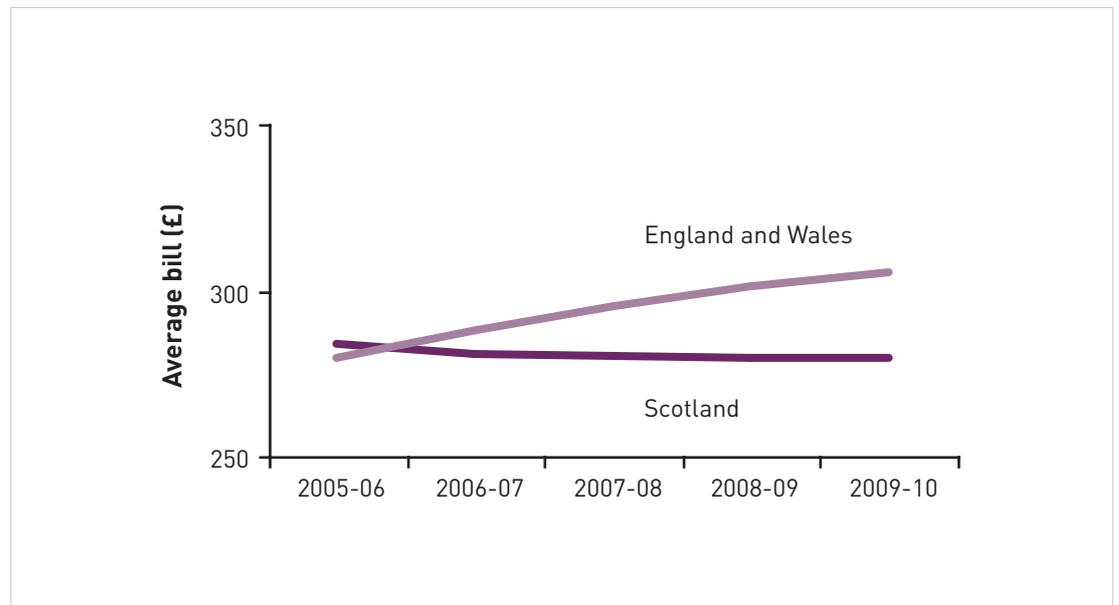
It is not in customers' interests to cut costs in any way that will have an adverse impact on the service that is provided to the customer. Nor is it acceptable to take short cuts with safety, public health or the environment. The Commission is pleased to report that at the same time as making efficiencies, Scottish Water has also improved its compliance with environmental and public health requirements (in line with ministerial requirements), and made improvements in many areas of customer service.

The Commission's 'Customer service report 2003-06' (published in September 2006) provided information about Scottish Water's customer service performance in 2003-06, and its plans to improve performance in specific areas of service. As well as monitoring progress in these areas, the Commission will also monitor Scottish Water's performance in delivering the remaining Quality and Standards 2 outputs<sup>16</sup>. We will publish updates in autumn 2007.

## Outlook for the future

Scottish Water has exceeded its own expectations in reducing costs. Last year, it agreed that further savings were possible over the next four years. As a result, household bills in Scotland will not rise above inflation. This is in contrast to the situation in England and Wales, as Figure 13 shows.

Figure 13: Average household bills in Scotland, and in England and Wales (in 2005-06 prices)



<sup>16</sup>Delivery of the remaining outputs is being monitored by the Output Monitoring Group. The group is made up of representatives from Scottish Water, the Drinking Water Quality Regulator, the Scottish Environment Protection Agency, the Scottish Executive, Waterwatch Scotland (the customer representative) and the Commission. The group meets quarterly to review Scottish Water's investment performance.

14.11.06



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