

Costs and performance report 2003-06

PERFORMANCE

Overview

This report examines Scottish Water's costs and its performance against the efficiency targets set at the Strategic Review of Charges 2002-06.

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More detailed findings in relation to Scottish Water's costs and its performance against the efficiency targets set at the Strategic Review of Charges 2002-06 are available on the Commission's website at www.watercommission.co.uk

Introduction

Context

Scottish Water spends around £750 million a year on day-to-day operations and investment¹. It supplies detailed information about these costs to the Commission. This information is used to examine Scottish Water's year-on-year performance and its performance against the regulatory efficiency targets.

The Commission also compares Scottish Water's performance with that of the water and sewerage companies in England and Wales. By 'benchmarking' Scottish Water's costs in this way, the Commission is able to establish the scope for Scottish Water to make further efficiencies, and so improve value for money to customers.

Please note that all numbers in this report are in outturn prices unless otherwise stated.

Associated documents

- 'Costs and performance report 2003-06: Detailed findings', Water Industry Commission for Scotland, November 2006.
- 'Costs and performance report 2002-03', Water Industry Commissioner for Scotland, November 2003.
- 'The Strategic Review of Charges 2002-06', Water Industry Commissioner for Scotland, November 2001.
- 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

¹ Scottish Water also spends around £120 million on Public Private Partnerships and around £140 million on interest payments.

KEY MESSAGES

Key messages

Scottish Water is getting more efficient

Scottish Water has become more efficient, responding well to the challenging but realistic targets that it was set in 2001. Efficiencies have been made in the two key areas of the business – Scottish Water’s day-to-day running costs (or ‘operating costs’), and its costs to maintain the pipes, sewers and water treatment works (or ‘capital costs’).

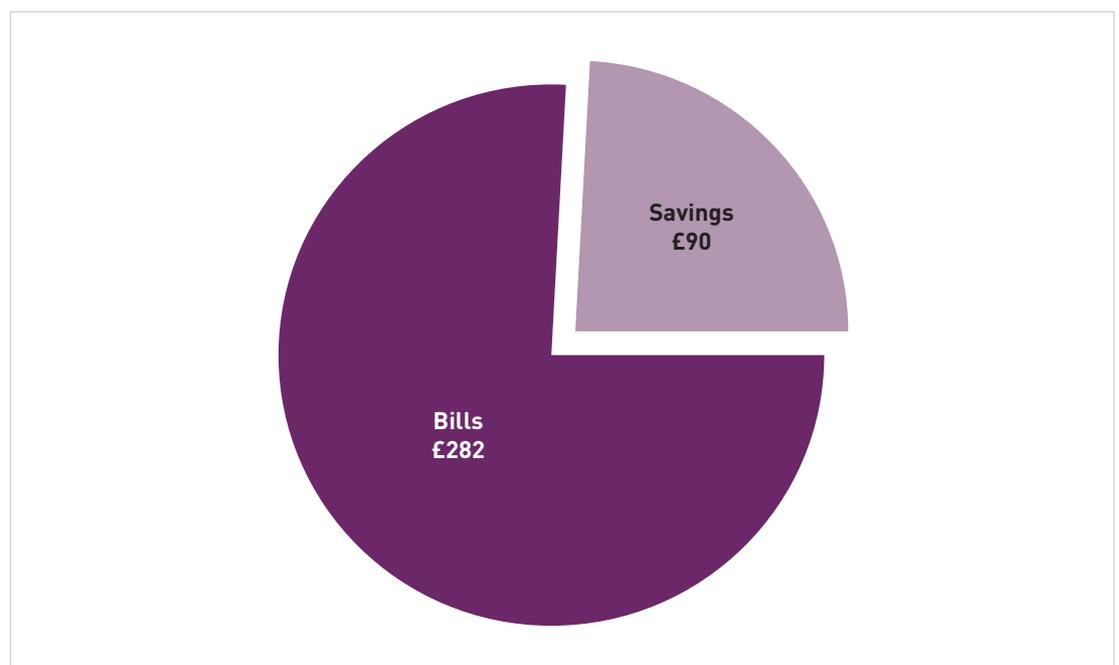
- Since 2002, Scottish Water has cut its annual running costs by almost 40%. In 2005-06 alone, the savings were just over £3 million each week.
- It is also achieving more than 20% better value for money on its capital costs since 2002. This created savings of around £5 million a week in 2005-06 alone.

The framework of regulatory targets, combined with determined management, is generating real benefits for customers. Scottish Water’s improvement means that it is catching up with the companies south of the border. At the same time as it has lowered costs, it has improved customer service and achieved better quality and environmental standards. The Commission welcomes this substantial improvement in Scottish Water’s performance over the past four years.

Customer bills are being kept down

Because of the improvement in Scottish Water’s performance, its customers are enjoying £90 a year off their bills. 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 1: How much customers saved last year (2005-06)



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

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

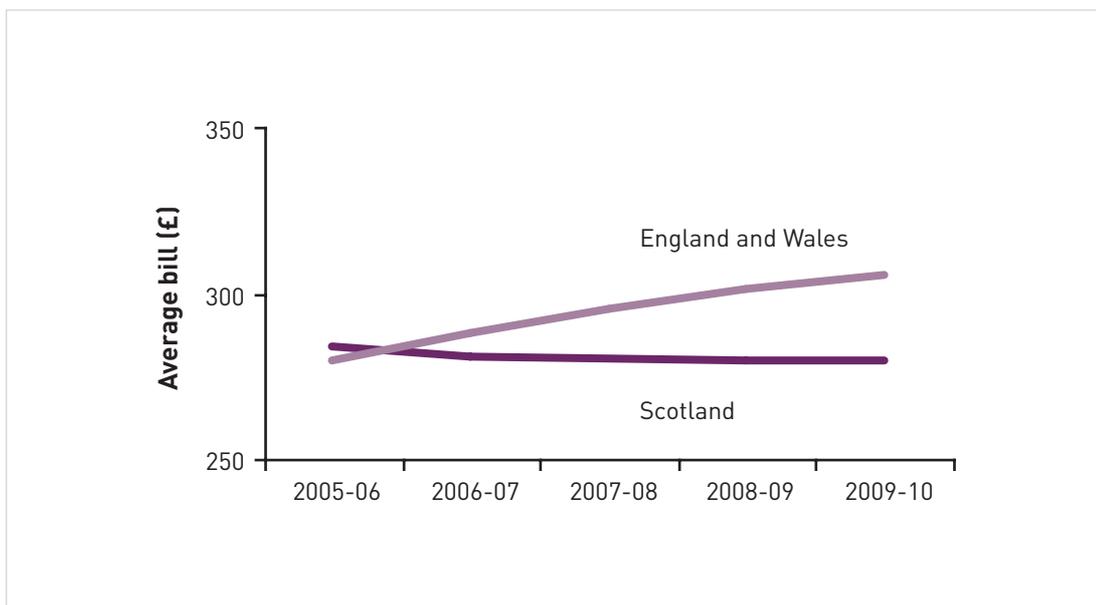
Table 1: Comparison of average utility bills in Scotland

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

Outlook for the future

Scottish Water exceeded its own expectations in reducing costs. Earlier this year, it agreed that further savings were possible over the next four years. As a result, household bills in Scotland will not rise; this is in contrast to the situation in England and Wales, as Figure 2 shows.

Figure 2: Average bills in Scotland, and in England and Wales (in 2005-06 prices)



Assessment of Scottish Water's costs and performance

At the Strategic Review of Charges 2002-06², the former Water Industry Commissioner for Scotland set targets for Scottish Water to improve its operating cost and capital efficiency. The efficiency targets he set were intended to limit bill increases in the regulatory control period and ensure value for money for customers.

Operating expenditure

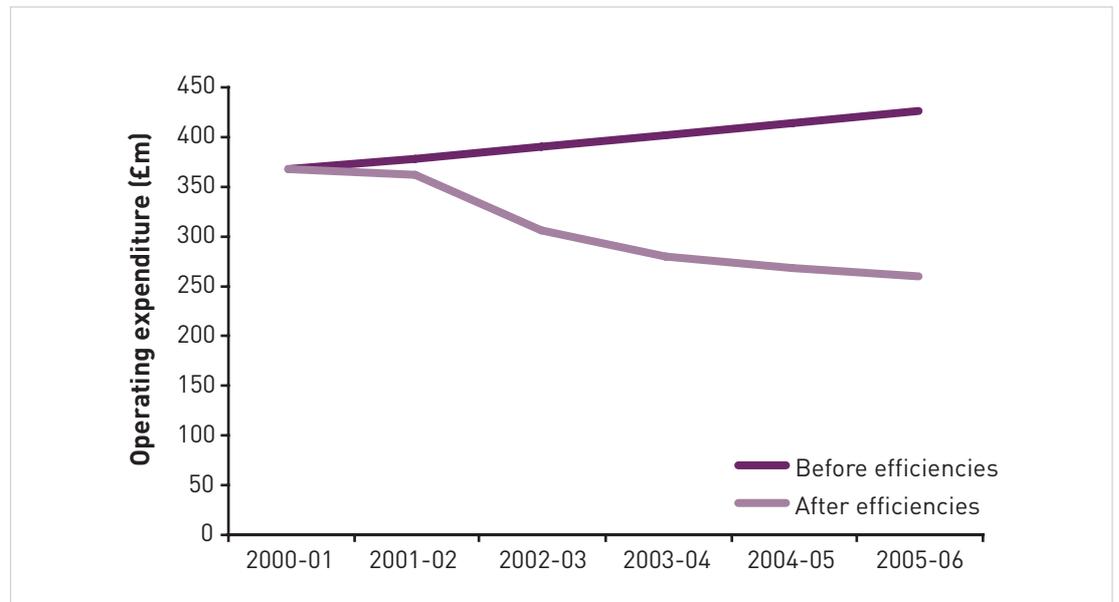
The operating cost efficiencies Scottish Water was required to deliver

The Commissioner established a 'baseline' for the operating costs to run the water and sewerage service in Scotland during the four-year regulatory control period. 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 on this basis.

Figure 3 shows the projected operating cost expenditure before and after the Commissioner's efficiency targets had been applied.

Figure 3: Allowed for operating expenditure (before and after efficiency targets)



² Published in November 2001.

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. The adjustments 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 laterals³.

It was agreed that the final-year operating target would be adjusted by £7 million.

The revised 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)⁴

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

Scottish Water was required to make operating cost savings of £509 million over the four-year period. In terms of its operating cost efficiency, Scottish Water was being set a challenge to improve its efficiency by almost 40% by 2005-06.

³ 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.

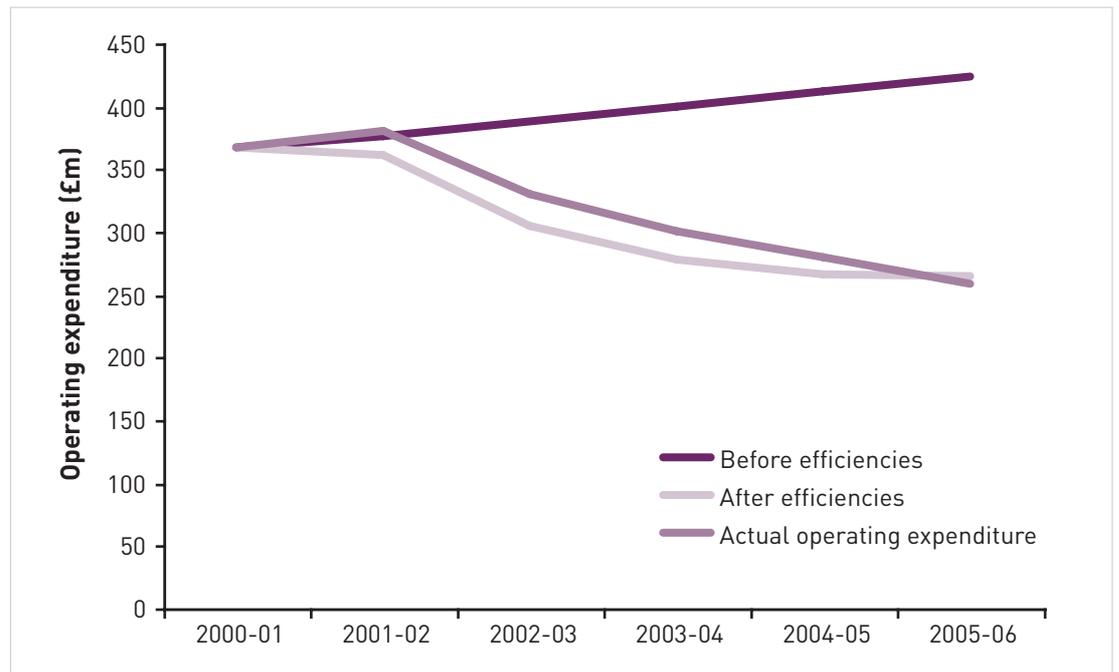
⁴ Figures may not add up, due to rounding.

How Scottish Water has performed on operating costs

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 4 shows how the actual operating costs compare with the targets that were set at the Strategic Review 2002-06⁵. Scottish Water achieved the operating cost target by the end of the period (ie in 2005-06).

Figure 4: Target and actual operating expenditure to March 2006

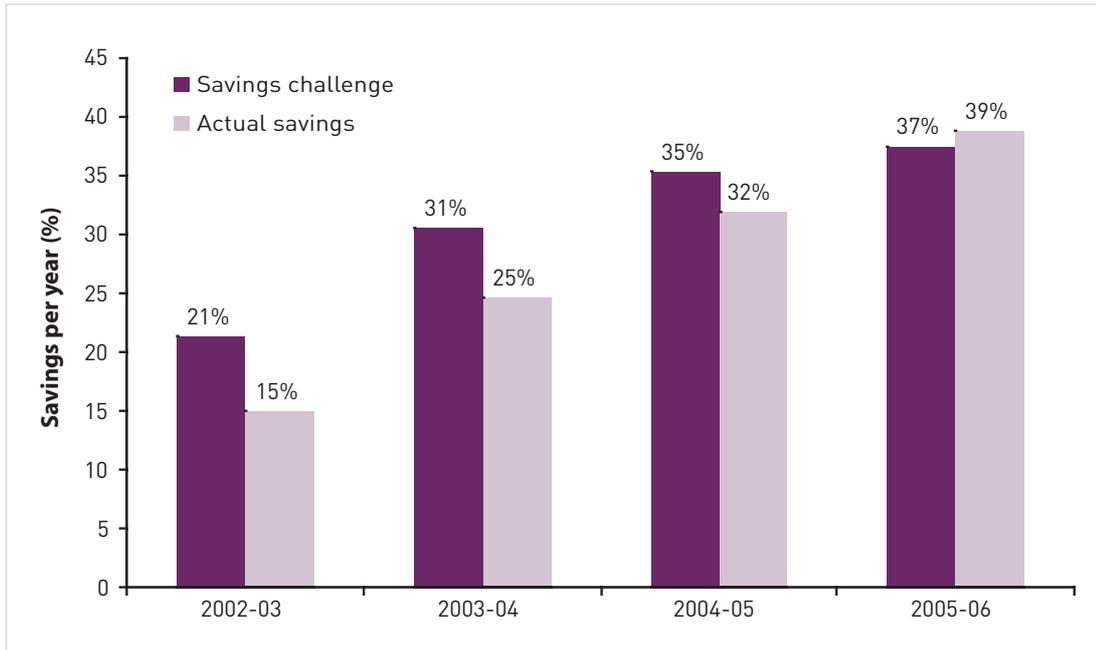


In 2005-06, Scottish Water spent £164 million less a year to run its business – saving more than £3 million a week. Over the four-year period, cumulative savings of £453 million have been generated.

In terms of its efficiency improvements, Scottish Water has reduced its operating costs by almost 40%, as Figure 5 shows. 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.

⁵ After the adjustment of £7 million to the target for 2005-06.

Figure 5: Operating cost efficiency improvements delivered by Scottish Water



Capital efficiencies

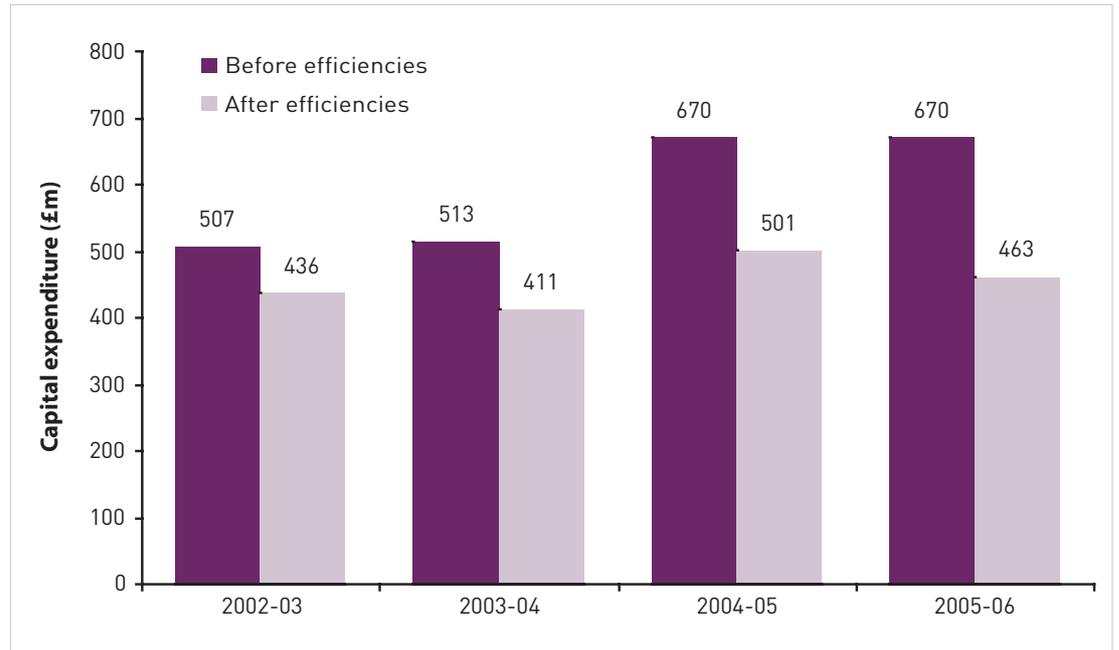
Introduction

Objectives for capital investment are determined by Scottish Ministers and delivered by Scottish Water through the 'Quality and Standards' process. 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 capital cost efficiencies Scottish Water was required to deliver

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. Once the Commissioner's efficiency targets had been applied, Scottish Water was required to deliver the same 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 reflect 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. The adjustments were not subject to any efficiency targets. The adjustments to the allowed for financing amounted to a total of £288 million.

The resulting regulatory contract

Table 3 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. It also highlights the capital expenditure savings that Scottish Water was required to make during the period.

Table 3: Allowed for capital costs (before and after efficiency targets and adjustments)⁶

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

Scottish Water was required to make capital savings of £613 million over the four-year period. As a result, it was being set the challenge of improving its efficiency by 31% by 2005-06. The challenge was phased gradually over four years, so amounted to a 24% improvement over the programme as a whole.

How Scottish Water has performed on capital costs

Figure 7 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.

⁶ Figures may not add up, due to rounding.

Figure 7: Capital cost performance against targets



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, a large number were still to be delivered by the end of the 2002-06 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 programme⁷; this relates to the difference between the revised allowed for capital expenditure (£2,098 million) and Scottish Water's actual forecast (£2,148 million⁸) 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 4 summarises the savings that have been made.

Table 4: Summary of performance 2002-06⁹

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

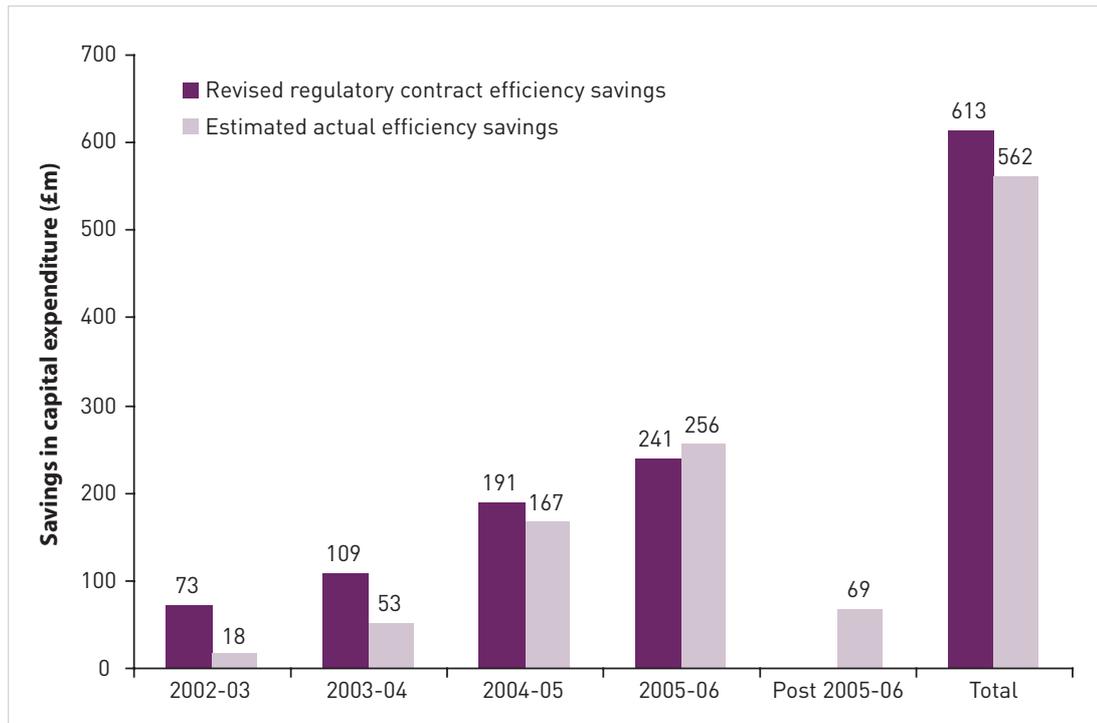
⁷ 'Investment and asset management report 2003-06'.

⁸ Excluding customer contributions.

⁹ Figures may not add up, due to rounding.

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 £560 million, relative to the baseline costs for delivering the full investment programme outputs that were indicated before any efficiencies. This is illustrated in Figure 8.

Figure 8: Capital cost savings achieved by Scottish Water



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%¹⁰.

The impact on customers' bills

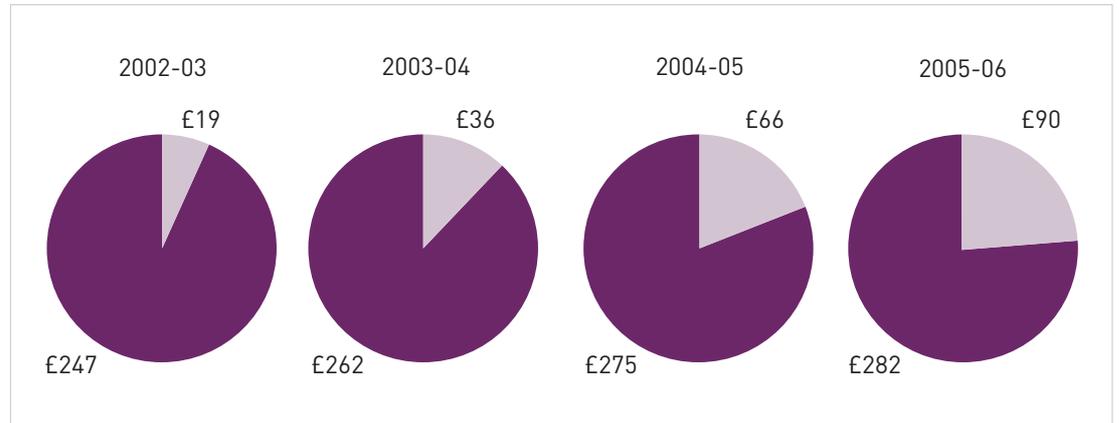
Over the four-year period, Scottish Water has delivered an estimated total of £946 million in savings. After taking account of the 'spend to save' allowance¹¹, the overall savings to customers from the operating cost and capital efficiencies that Scottish Water has achieved in the past four years is estimated at £746 million.

As a direct result, 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 9 shows how much customers have saved in their bills for each year of the regulatory control period.

¹⁰This 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).

¹¹In 2001, Ministers agreed a specific allowance of £200 million for Scottish Water to spend on initiatives to reduce its costs going forward and to help it achieve the efficiency targets.

Figure 9: How much customers have saved on their bills¹²



Looking forward

The Commission welcomes the substantial improvement in Scottish Water's performance over the past four years. 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.

The Commission's 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.

¹²Figures for savings are shown gross of 'spend to save'.

14.11.06



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