

## Costs and performance 2008-09

PERFORMANCE



### Overview

This report examines Scottish Water's costs and performance in 2008-09.

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## INTRODUCTION

### Context

It is our role to monitor Scottish Water's performance to ensure that it delivers the benefits customers have paid for. Ministers set objectives to improve water quality, environmental performance and customer service. We set prices that give Scottish Water sufficient resources to meet these objectives provided it meets our efficiency targets. We measure Scottish Water's progress in delivering the objectives and publish our assessment in an annual investment report.<sup>1</sup>

Ministerial objectives cover each regulatory control period. Therefore the level of outperformance (if any) of a regulatory contract can only be determined after all objectives have been confirmed as delivered.

This report considers Scottish Water's day-to-day operating costs for the year 2008-09 and performance against targets set at the 2006-10 review. Operating costs account for around a quarter of the money Scottish Water spends.

We are now in the final year of the 2006-10 regulatory control period. We recently published our draft determination for the next regulatory control period, which considers both operating costs and capital expenditure going forward. We will publish our final determination on 26 November 2009.

### Associated documents

- 'Costs and performance report 2007-08', February 2009.
- 'Investment report 2007-08', October 2008.
- 'Customer service report 2008-09', October 2009.
- 'The Strategic Review of Charges 2006-10: The final determination', November 2005.
- 'The Strategic Review of Charges 2010-14: The draft determination', June 2009.

<sup>1</sup> Our 'Investment report 2008-09' is due to be published later this year.

# KEY MESSAGES

## KEY MESSAGES

We cannot undertake definitive analysis of whether Scottish Water has outperformed or underperformed in its capital expenditure programme (that is, spending to maintain and improve its assets) until after the end of the 2006-10 regulatory control period. However, we are pleased to note that in 2008-09, Scottish Water's level of operating costs was within the levels that we assumed when setting prices for the 2006-10 period. This includes the additional costs that Scottish Water has incurred in tackling leakage.

It should be noted that 2008-09 was the first year of operation of the competitive retail market for non-household water and sewerage services. Scottish Water has successfully restructured its business and now only acts as wholesaler to the licensed providers and as retailer to households. This report considers Scottish Water's wholesale operating costs for 2007-08 and 2008-09. These are the only years for which we have collected consistent information on the costs of the business excluding retail operations to non-household customers.

The incentive framework that was put in place at the 2006-10 final determination appears to be generating benefits for customers. During 2010-15, Scottish Water is expected to make further savings and customers can look forward to broadly stable bills as a result.

Scottish Water's ownership requires that, on an ongoing basis, the Scottish Government commits substantial public expenditure to the water and sewerage industry in Scotland. It is essential that Scottish Water continues to have access to new debt finance in order to deliver all of its required outputs over a regulatory control period. Given the challenges that Scottish Water faces in adapting to and mitigating climate change and in pursuing environmental and public health improvements, there is likely to be an ongoing need to improve its assets. Such improvements are best financed through a combination of borrowing and customers' charges.

## PERFORMANCE ASSESSMENT

### Recent movements in operating costs

Scottish Water reduced its operating expenditure by 40% between 2002-03 (when it was formed from the three former water authorities) and 2007-08. This performance is now a matter of historical record. Although customers will expect Scottish Water to continue to make savings in its operating costs, it will have less scope for further significant reductions in operating costs in future.

Scottish Water’s operating expenditure increased from £267 million in 2007-08 to £290 million in 2008-09<sup>2</sup>. After adjusting for one-off costs or savings, the underlying increase was around 6%.

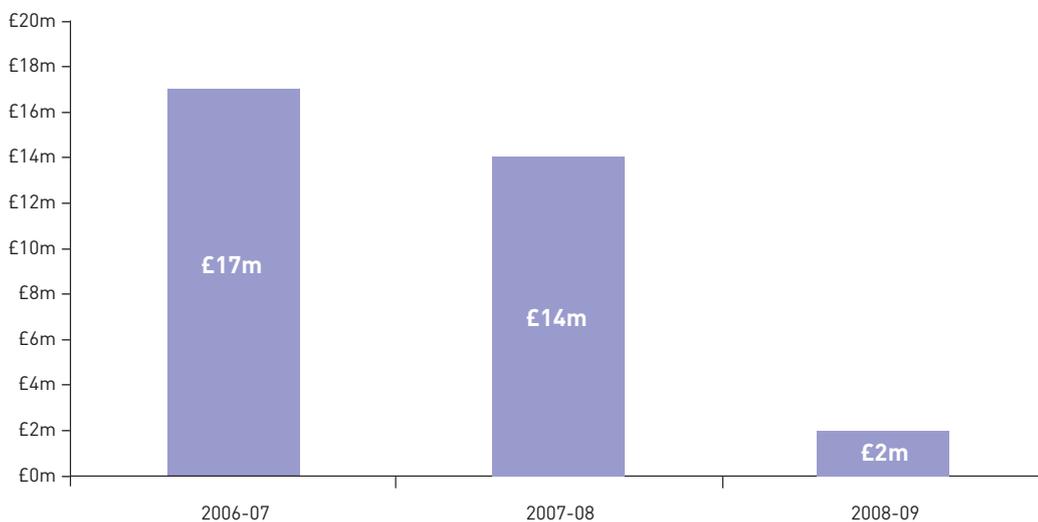
The increase mainly relates to additional expenditure during 2008-09 on leakage detection and control activity, an important issue for both customers and the environment. We were pleased to note in our recent 2008-09 customer service report that Scottish Water had outperformed its leakage target.

Although Scottish Water’s operating costs increased in 2008-09, they were still within the levels that we assumed when setting prices for the 2006-10 period.

### Outperformance of regulatory allowances

Figure 1 shows Scottish Water’s outperformance of operating costs for the three years from 2006-07 to 2008-09. Outperformance against the allowances made for operating expenditure has varied from year to year, and fell significantly in 2008-09. This highlights the fact that a surplus in any one year does not mean that the resources will not be needed in future years. The section on governance overleaf considers this issue in more detail.

**Figure 1: Annual outperformance of operating costs**



<sup>2</sup> All figures in this report are expressed in 2008-09 prices.

## A CLEAR INCENTIVE AND GOVERNANCE FRAMEWORK

At the last Strategic Review of Charges, we put in place a clear framework to strengthen the governance of Scottish Water and create appropriate organisational incentives. These involved:

- proper limits on Scottish Water's costs – if managers fail to meet expectations, costs will be met from public expenditure, not from customers;
- a temporary loan facility (£50 million until 2010) to cover unexpected costs such as emergencies or changes in legal obligations, but not the costs of management failure;
- a growing savings account (a 'financial reserve' and potentially 'gilts buffer'), financed by outperformance of our expectations;
- transfer of savings to customers after four years, keeping bills down;
- bonuses to Scottish Water's management that can only be paid when our expectations are beaten; and
- formal scrutiny every three months of Scottish Water's delivery of the investment benefits required by Scottish Ministers.

This framework has worked well to date, and it is imperative that it is maintained going forward.

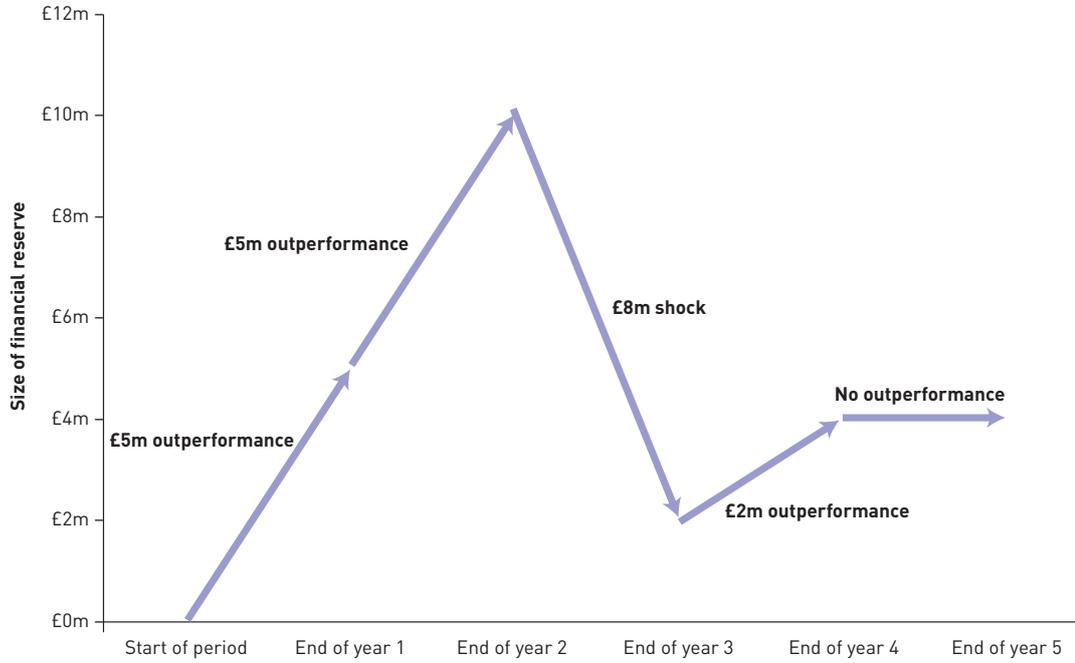
The financial reserve is especially important, as it allows Scottish Water flexibility to manage its business effectively over a full regulatory control period, and to benefit from outperforming regulatory expectations. If Scottish Water performs better than we expected on its costs from year to year, it builds up a reserve of cash. The reserve (or buffer) could serve in part as a shock absorber between the necessary multi-year planning horizon of Scottish Water and the shorter term public expenditure framework. It could also serve as a contingency which could, subject to the agreement of the Commission, be available to Scottish Water to cover costs outside the control of management that may otherwise have led to an interim determination.

There can be no guarantee of the extent to which a regulatory contract has been outperformed until the regulatory control period has ended. Specifically, although measurement of outperformance in operating costs, revenue or property/asset disposals becomes clear almost immediately, actual outturn costs on the capital expenditure programme will only be clear once the programme as a whole has been delivered.

As Figure 2 illustrates, it may be that higher costs in a later year may offset outperformance earlier in the period and reduce the value of funds in the reserve. In the example, if it had been assumed after year 2 that £10 million was the value of outperformance, this would have left Scottish Water short of finance in the remaining years and overstated the eventual value of the buffer.

We therefore believe that it would be inadvisable to spend or commit apparent outperformance against the regulatory contract until there is full clarity about the capital programme.

**Figure 2: Example of financial reserve**



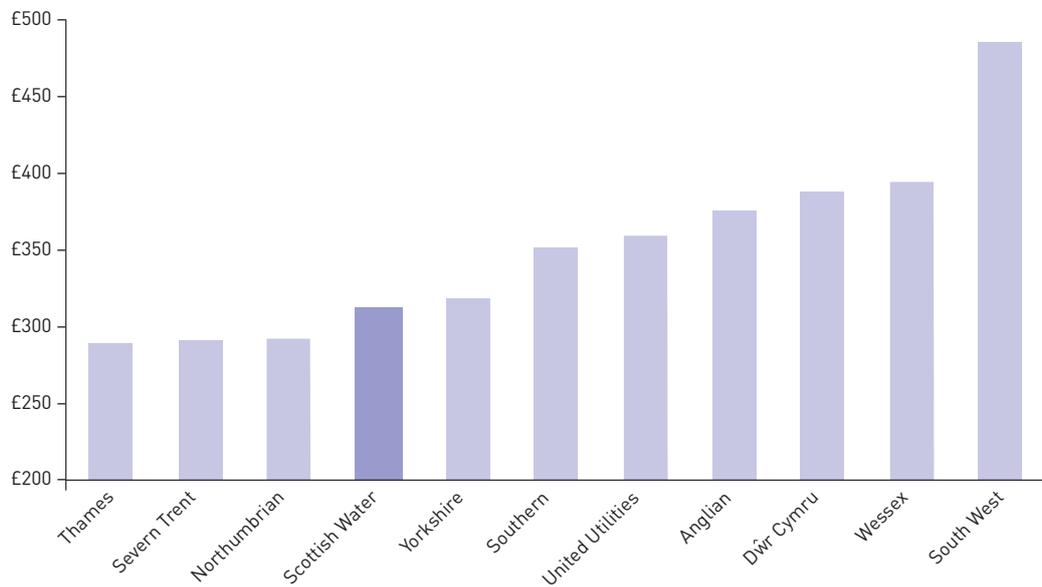
If Scottish Water sustains its outperformance on costs to the end of the regulatory control period, any resulting reserve can be invested in index-linked, gilt-edged securities. This buffer is an important mechanism to protect customers against risks and uncertainties, and is accessible to Scottish Water only with the agreement of Ministers.

## IMPACT OF PERFORMANCE ON CUSTOMERS' BILLS

Customers are seeing the benefits of Scottish Water's performance in maintaining a tight control on operating costs. In 2008-09 the average household bill in Scotland was £312. This is £20 lower than the average for the water and sewerage companies in England and Wales.

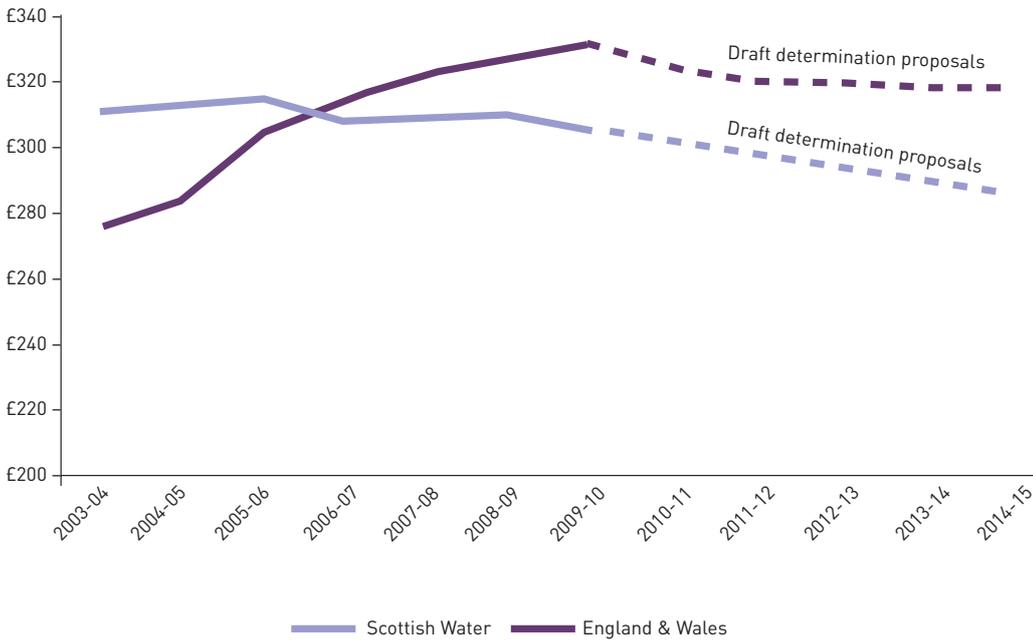
As Figure 3 shows, household bills in Scotland are amongst the lower end of the range of the companies in England and Wales.

**Figure 3: Average household bills in 2008-09**



It is possible to compare likely household bills in Scotland with those projected for England and Wales. Figure 4 shows past movements in the average household bill for Scotland and for England and Wales, as well as proposed average bills up to 2015.

**Figure 4: Comparison of average household bills in Scotland and in England and Wales 2003-04 to 2014-15 (2008-09 prices)**



The numbers are based on the draft price limits for the companies in England and Wales proposed by Ofwat and those that we have proposed for Scottish Water, using the best information currently available. As such, the forecasts may change following publication of the final determinations on both sides of the border. However, the forecasts do provide an indication of the relatively positive outlook for bills in Scotland.

CUSTOMERS' BILLS

# LOOKING FORWARD

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Scottish Water has come a long way since it was established in 2002. It has reduced its operating costs significantly and, at the same time, improved the level of service it provides to customers.

In the next regulatory control period, covering 2010-15, Scottish Water is expected to make further savings and customers can look forward to broadly stable bills as a result.

Scottish Water's ownership requires that, on an ongoing basis, the Scottish Government commits substantial public expenditure to the water and sewerage industry in Scotland. We understand that the terms by which the Government makes borrowing available to Scottish Water may be less flexible now than in the past. Given the challenges that Scottish Water faces in adapting to and mitigating climate change and in pursuing environmental and public health improvements, there is likely to be an ongoing need to improve its assets. Such improvements are best financed through a combination of borrowing and customers' charges.



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