

Overview of the water industry in Scotland

Key messages / Prepared for the Auditor General for Scotland

October 2005



Key messages

Introduction

1. Scottish Water was established in April 2002 from a merger of the three previous water authorities. Its main functions are to provide clean water to 2.2 million households and 133,000 non-domestic, mainly business, properties in Scotland; and to treat their wastewater, such as waste from bathrooms and kitchen sinks. It is funded largely from charges to customers, and from borrowing approved by the Scottish ministers.

2. Scottish Water is the fourth-largest water services provider in the UK and one of the 20 largest businesses in Scotland. It has an annual turnover approaching £1 billion, and it has been estimated that its capital assets, such as water treatment works and sewer networks are worth £28.2 billion at full replacement cost.

3. In November 2002, the Auditor General published his report *Overview of the 2001/02 water authority audits* considering the 2001/02 audits of the three previous water authorities. The report identified issues arising from the merger which Scottish Water needed to address. It promised a further report on progress.

4. This report examines:

- Scottish Water's progress since its establishment
- how the Scottish water industry is regulated.

Key findings

1. Scottish Water has made good progress with the merger of the three previous water authorities and has developed generally robust corporate governance arrangements. It has responded to the Auditor General's *Overview of the 2001/02 water authority audits* report.

- Scottish Water's corporate governance and financial controls are sound, and the recommendations made in the Auditor General's earlier report have been addressed.
- A Transformation Programme has realised many of the benefits of merger and achieved operating efficiencies. Many of the projects in the Programme are now complete and some significant changes have been made, for example, staffing levels have reduced by a third, from 5,650 to 3,750.

2. The regulation of the Scottish water industry is complex. Recent changes to how it is regulated are intended to make it more effective and open to public scrutiny.

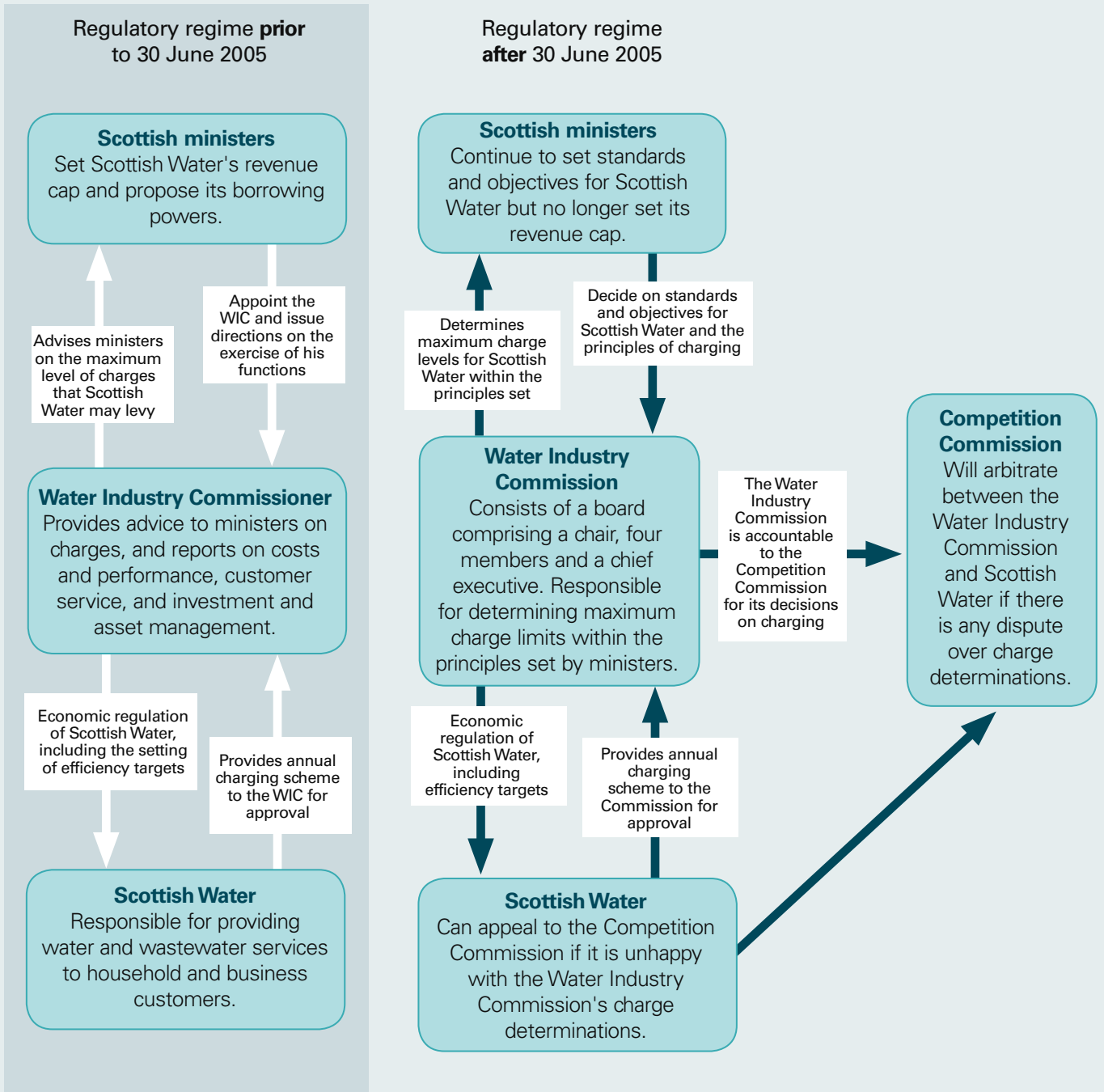
- Economic regulation is needed to protect the interests of water customers, since Scottish Water's monopoly position means that customers have little or no choice about who provides them with water and sewerage services. The Water Industry Commissioner (WIC) has carried out this role since Scottish Water was

formed in 2002, giving advice to ministers on the amount of income Scottish Water can generate from customer charges, efficiency targets and charge levels, but there have been problems with this regulatory regime. The identification of direct comparators and a lack of transparency have led to disagreements between the WIC and Scottish Water.

- In 2001, the WIC published his advice to ministers for 2002 to 2006, recommending:
 - annual revenue caps
 - harmonised water charges
 - the development of tariffs that reflected the actual cost of providing water services to different customer groups.
- Scottish Water challenged some of the WIC's conclusions in the first draft of its Strategic Business Plan in 2002. The Scottish Executive brokered Terms of Understanding between the WIC and Scottish Water, designed to foster better working relationships. Scottish Water's *Strategic Business Plan* was finally published in September 2003.
- The Commissioner has now been replaced with a Water Industry Commission ([Exhibit 1](#)). The Commission will be responsible for determining Scottish Water's maximum charge limits, based on principles set by ministers. The challenge for the Commission, Scottish Water and the Scottish Executive now, is to demonstrate that regulation is effective and transparent.

Exhibit 1

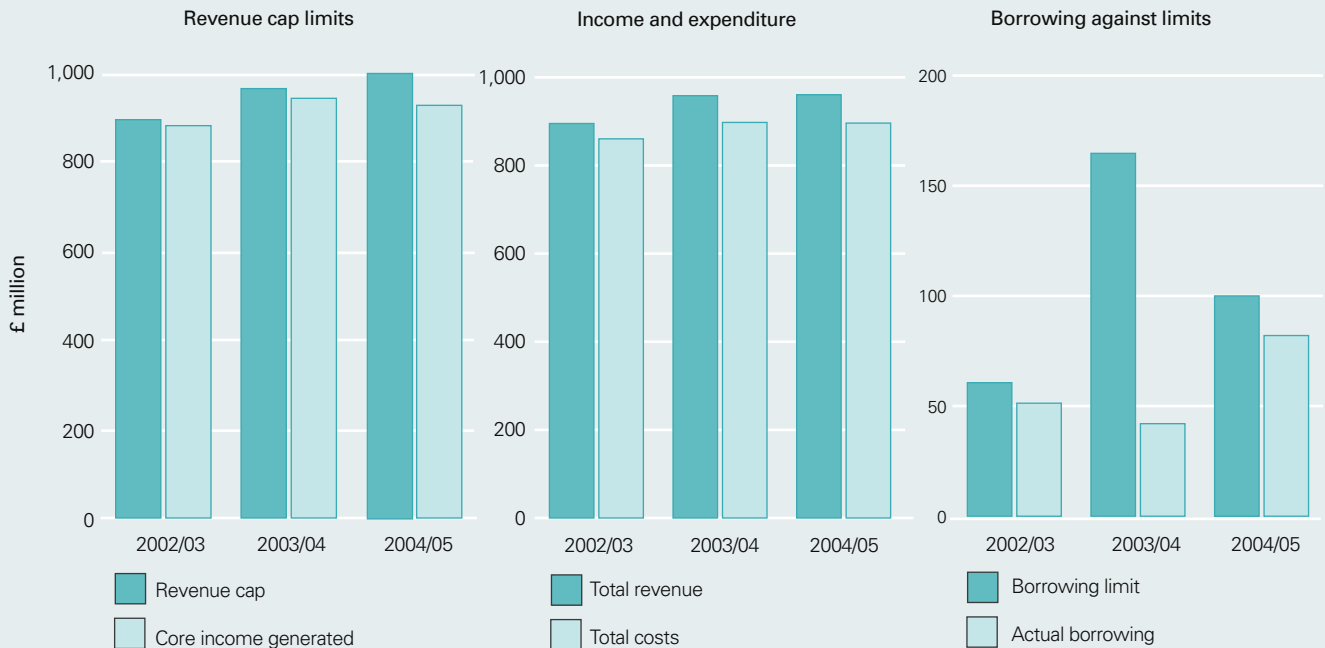
Changes to the economic regulation of Scottish Water



Source: Audit Scotland

Exhibit 2

Scottish Water's performance against its financial targets



The financial framework within which Scottish Water operates requires it to cover its annual operating costs from charges to customers, to contain revenue to within maximum limits set by ministers and to stay within borrowing limits contained in Budget Acts. Scottish Water has achieved these targets in each of its first three years.

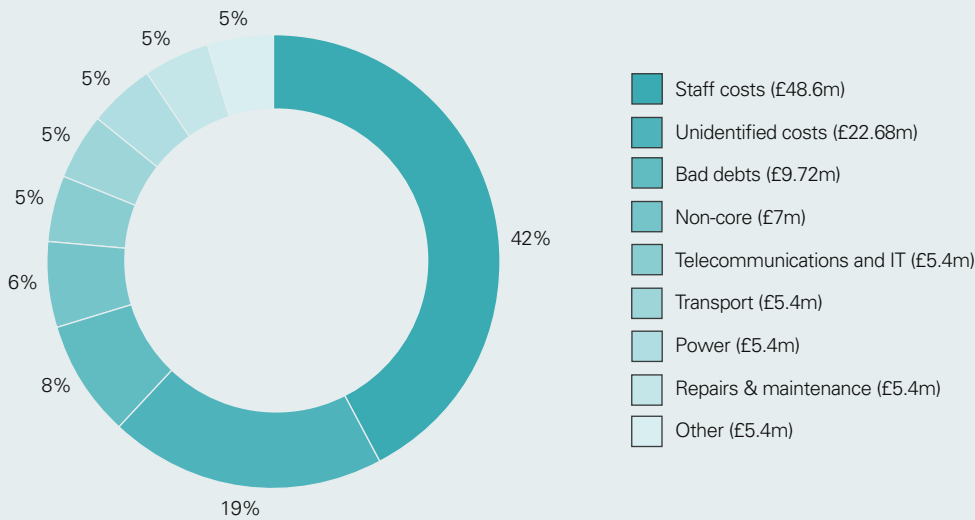
Source: Audit Scotland

3. In its first three years, Scottish Water has achieved its statutory financial targets, reduced its operating costs significantly and has made some progress in improving the efficiency of its capital investment programme. It still faces significant challenges in delivering its capital investment programme to 2006 while achieving the efficiency savings demanded by the WIC.

- Benefits expected from the creation of Scottish Water were increased efficiency and competitiveness, better value for money from economies of scale and harmonisation of customer charges.
- In its first three years, Scottish Water generated financial surpluses which have been reinvested in the business. It has stayed within annual revenue caps set by ministers and has not exceeded its borrowing levels (Exhibit 2).
- Scottish Water has reduced its annual base operating costs by almost £100 million since it was created. It is confident that it will achieve the WIC's target for it to reduce operating expenditure to £265 million by 2005/06, largely through the projects in its Transformation Programme (Exhibit 3, overleaf).
- Some efficiency improvements have also been achieved through Scottish Water's capital investment programme, but it is less clear whether efficiency targets will be achieved by 2005/06. The Quality and Standards II programme was expected to achieve £1.8 billion investment in new and replacement assets, mainly to improve drinking water quality and wastewater treatment. We will not know whether this has been achieved until the programme is complete. It is estimated that £253 million of Q&S II projects will remain to be completed at April 2006. The Auditor General is carrying out a more detailed study of Scottish Water's capital investment, which is due for publication before the end of 2006.
- Scottish Water harmonised charges for business customers in 2003/04 and for domestic customers in 2004/05. For the average customer previously served by the East and West of Scotland Water Authorities, this has meant charges rising faster than inflation. But for the average customer living in the North of Scotland, charges have fallen in real terms.

Exhibit 3

Scottish Water's planned operating efficiency savings



Source: *Strategic Business Plan 2003-06*, Scottish Water

4. Scottish Water has met most of its own customer service performance measures but the WIC considered that performance fell short of that of water companies in England and Wales.

- The WIC's approach to measuring Scottish Water's customer service performance was based on a methodology developed by Ofwat, which he considered to be well-regarded. He considered that Scottish Water's overall customer service performance in 2002/03 was significantly worse than that of the poorest performing water company in England and Wales.
- But Scottish Water considers that these comparisons did not put its performance fully in context. It has its own set of performance measures, covering customer service, billing enquiries, asset management and finance. It met 9 of the 10 targets in 2004/05 ([Exhibit 4, overleaf](#)).

5. The quality of Scotland's drinking and surface water is improving. Fewer samples fail relevant standards for drinking water quality and Scottish Water's investment in wastewater treatment works is helping to improve surface water quality, including the quality of bathing waters.

- The EC sets the framework for water quality which is overseen by the Drinking Water Quality Regulator for Scotland and the Scottish Environment Protection Agency.
- There has been a steady improvement in the microbiological quality of drinking water since the early 1990s. Overall, fewer than 1% of tap samples now fail to meet the relevant standards.

- Fifty-six of Scotland's 60 bathing water beaches reached EC mandatory standards in 2004. Only one of the bathing water failures in 2004 was attributable to Scottish Water discharges.
- Scottish Water's investment in wastewater treatment works is helping to improve surface water quality. Nevertheless, sewage discharges are a contributing factor in well over half of polluted rivers, estuaries and coastal waters in Scotland. Ministers have set further targets to improve water quality through Scottish Water's next capital investment programme from 2006 to 2014.

Exhibit 4

Scottish Water's customer service targets and performance for 2002/03 to 2004/05

		Target met
Customer service	Number of written complaints*	N/A
	Number of enquiries (telephone and written)*	N/A
	Guaranteed Minimum Standards compliance	✓
	% response to all complaints within ten days	✓
	% calls answered within 30 seconds	✓
	% calls abandoned	✓
Billing enquiries	Number of accounts written complaints*	N/A
	Number of accounts enquiries*	N/A
	% response to accounts enquiries within ten days	✓
Asset management	Number of properties removed from 'at risk' flooding register	✓
	Number of properties affected by unplanned interruptions > 12 hrs	✓
	Number of interruptions to trunk mains lasting > 48 hrs	✓
Debt collection	Overdue debtor days – business customers	✗
	Household customers – collection performance	✓

Note: * Scottish Water regards these indicators as measures of activity and does not assign targets to them.

Source: *Strategic Business Plan 2003-06*, Scottish Water

Key recommendations

- Overall, Scottish Water has established a sound basis for strategic planning, business planning and performance reporting, but there is still scope for improvement.
- The regulation of the water industry in Scotland is complex. Robust regulation is appropriate for a public service monopoly, but those involved need to co-operate to ensure transparency and to minimise the regulatory costs. In particular, there is a need to develop a clearer

understanding of how Scottish Water's core costs are attributed between different customer groups and services, and to ensure that Scottish Water submits accurate information to the Water Industry Commission. It is important that any customer service targets and performance indicators which the Water Industry Commission sets, provide a full picture of Scottish Water's performance so as to enhance regulatory transparency and provide clarity for stakeholders.

- Scottish Water has made significant improvements in efficiency and performance, but there is scope for more. In particular, its capital programme is essential to deliver quality and efficiency improvements, but it will be challenging within the timescale set. We plan to undertake a study of this issue and will report before the end of 2006.

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