

A REPORT BY THE AUDITOR GENERAL FOR SCOTLAND UNDER SECTION 22(3) OF THE  
PUBLIC FINANCE AND ACCOUNTABILITY (SCOTLAND) ACT 2000**THE 2006/2007 AUDIT OF SCOTTISH WATER**

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1. I have received the audited accounts of Scottish Water for the year ended 31 March 2007. The auditor has provided a clean certificate on the accounts. I have decided to issue this report to bring to the Parliament's attention Scottish Water's progress in improving its efficiency and customer service.
2. I submit these accounts and the auditor's report in terms of sub-section 22(4) of the Public Finance and Accountability (Scotland) Act 2000, together with this report which I have prepared under sub-section 22(3) of the Act.

**Scottish Water's efficiency**

3. The financial performance of Scottish Water is of direct importance to the people of Scotland because a significant proportion of its funding is generated from household and business customers. Under the regulatory regime which operated prior to July 2005, the Water Industry Commissioner for Scotland (the Commissioner) set efficiency targets covering the four years from March 2002 to April 2006 to challenge Scottish Water to improve its performance and offer better value for money to its customers. The targets covered both Scottish Water's operating costs and its capital expenditure.

*Operating cost efficiency*

4. In respect of operating costs, the Commissioner expected Scottish Water to cut its annual operating expenditure relative to 2000/01 by £83 million in 2002/03, rising to £158 million in 2005/06. Most of these savings were expected to come from significant reductions in its workforce, redesigning processes and systems, investing in automation and as a direct consequence of the merger of the three previous water authorities in April 2002. If the savings target was achieved, it would reduce Scottish Water's annual operating expenditure by 37% to £265 million in 2005/06 on a like for like basis.
5. In my report '*Overview of the water industry in Scotland*' published in October 2005, I reported that the Commissioner had found that Scottish Water had reduced its base operating costs by £29.3 million to £351.2 million in 2002/03. Although this fell £46.9 million short of the Commissioner's expectations, Scottish Water had subsequently reduced operating costs by a further £70 million and was confident that that it would meet the final target of £265 million by 2005/06.
6. The Water Industry Commission for Scotland (the Commission), which replaced the Commissioner as the economic regulator of Scottish Water in July 2005, produced a further report on Scottish Water's efficiency in November 2006<sup>1</sup>. The Commission found that Scottish Water had achieved the 2005/06 target by reducing its base operating costs to £259 million for the year. Over the four-year period between 2002/03 and 2005/06, Scottish Water has generated cumulative savings of £453 million in operating expenditure.
7. Scottish Water reported further progress in improving its operating efficiency in its 2006/07 annual reports and accounts. It reported reducing base operating costs by a further 5% compared to the previous year despite some significant increases in certain costs. For example, power costs increased by £5.8 million to £27.3 million (a 27% increase).

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<sup>1</sup> *Costs and performance report 2003-06*, Water Industry Commission for Scotland, November 2006

### *Capital expenditure efficiency*

8. Scottish Water started the third of three planned capital investment programmes designed to improve and replace ageing assets to meet tighter standards for drinking water quality and wastewater treatment in April 2006<sup>2</sup>. The Commissioner's target for the second of these investment programmes, covering the period April 2002 to March 2006, was to improve the efficiency of capital expenditure relative to 2000/01 by £73 million in 2002/03 rising to £241 million in 2005/06. Overall, the Commissioner expected Scottish Water to deliver the second investment programme for £1,811 million, representing an efficiency saving of £549 million over the four-year period to March 2006.
9. The Commissioner concentrated his monitoring of capital expenditure efficiency on procurement efficiency because he considered this could be measured objectively on an annual basis. In 2002/03, the Commissioner calculated that Scottish Water improved its procurement efficiency by 5% in real terms. While welcoming this improvement, he expressed concern at the rate of Scottish Water's investment at that time. Scottish Water invested £743 million in the first two years of the investment programme, leaving more than £1 billion to be invested in the remaining two years.
10. In their October 2006 report<sup>3</sup>, the Commission noted that adjustments had been made to the original capital expenditure efficiency target to reflect 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 revised target required Scottish Water to make capital efficiency savings of £613 million over the four-year period to March 2006.
11. In their October 2006 report, the Commission found that Scottish Water delivered 86% of the outputs it was required to deliver during the 2002-06 investment programme by March 2006. The remaining outputs now require to be delivered during the 2006-2010 period. Overall, the second investment programme is expected to cost £2,166 million compared to the Commission's gross allowance of £2,110 million. Nevertheless, the Commission calculates that Scottish Water achieved capital efficiency savings of £494 million during the period between April 2002 and March 2006.

### **Scottish Water's customer service performance**

12. The Commissioner, and now the Commission, monitors the level of service that Scottish Water provides to its customers using a performance assessment framework which takes into account a number of measures including drinking water quality, leakages, unplanned supply interruptions, flooding and complaints handling. The methodology used enables Scottish Water's overall customer service performance to be expressed as a single score so that performance can be compared over time and between water companies in England and Wales.
13. I previously reported that the Commissioner found that Scottish Water's overall customer service performance score in 2002/03 was 38% of that of the worst performing water company in England and Wales. While Scottish Water compared reasonably well with water companies in England and Wales on a few individual performance measures, its performance was often worse than the average for England and Wales and was sometimes the lowest.

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<sup>2</sup> The first of these investment programmes was begun by Scottish Water's predecessors, East of Scotland Water, North of Scotland Water and West of Scotland Water. Scottish Water has sole responsibility for the second and third investment programmes.

<sup>3</sup> *Investment and asset management report 2003-06*, Water Industry Commission for Scotland, October 2006

14. In its follow-up report in September 2006, the Commission found that Scottish Water had made significant improvements in its customer service performance<sup>4</sup>. Overall, Scottish Water's customer service performance improved by 24% between 2002/03 and 2005/06 allowing Scottish Water to narrow the gap with water companies in England and Wales. While the level of service in Scotland remains poor for individual measures addressing sewage treatment and customers experiencing inadequate water pressure, the Commission considered that Scottish Water's efforts to improve the service it provides to customers should be recognised.
15. Scottish Water reported that during 2006/07, it bettered the target set by the Commission for its customer service performance by 17%. Reported key achievements included the removal of over 5,200 properties from the low water pressure register, a 63% reduction in sewer flooding incidents compared to the previous year and a reduction of almost 5,300 properties affected by unplanned interruptions to supply lasting longer than six hours. Drinking water quality also continues to improve.

### **Conclusions**

16. Scottish Water made significant improvements in its efficiency and customer service in the period March 2002 to April 2006 and has reported that it continued to do so in 2006/07. Scottish Water reported that taken together, these improvements mean that the average household water bill is £100 less than it otherwise would have been.
17. Nevertheless, Scottish Water still faces significant challenges in the years ahead. The Commission's new targets covering the four-year period to March 2010 will require Scottish Water to contain its operating expenditure such that customers' bills will rise at less than the rate of inflation and to deliver the third capital investment programme at a cost of £2.15 billion (in 2003/04 prices). It is vitally important therefore, that Scottish Water continues to pay close attention to its operating costs and capital investment programme, not least so that it can respond when the supply of water and sewerage services to non-household customers is opened to competition from April 2008. I will continue to monitor Scottish Water's performance in the years ahead and may consider a further report to Parliament in due course. The Commission is also expected to report on Scottish Water's performance for 2006/07 in the autumn.

A stylized, handwritten signature in black ink that reads "Autoblade".

**Robert W Black**  
**Auditor General for Scotland**  
**9 August 2007**

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<sup>4</sup> *Customer service report 2003-06*, Water Industry Commission for Scotland, September 2006