

# Annual Return 2005/06

## Overview

### DOCUMENT CONTROL

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# 1. Executive Summary

## 1.1 Scottish Water Performance in 2005/06

In 2005/06 Scottish Water has made further progress in terms of efficiencies, systems rationalisation and in improvements to customer service. Our key achievements in 2005/06 are highlighted below.

### Service

We have increased customer satisfaction levels during the year from 93% in April 2005 to 95% in September 2005 as measured through an independent survey. Over the 4 year strategic review period our customer satisfaction has increased from 75% to 95%.

Our performance against our published guaranteed standards of service improved from 96% in 2004/5 to 98% in 2005/06. This compares with 91.4% at the formation of Scottish Water.

Our performance against key levels of service indicators improved for:

- connected properties experiencing unplanned interruptions greater than 12 hours;
- percentage of water samples complying with parameters;
- percentage of billing contacts responded to within 10 days; and
- percentage of written complaints responded to within 10 days.

We again maintained unconstrained supplies to all our customers during the report year.

We have continued to improve our collection of charges in the household sector and the business sector. In the business sector, we have reduced aged debt by 72% since the formation of Scottish Water

Our clean up response times for sewer flooding incidents, being cleaned up in less than 4 hours, have improved from 51% in 2001/02 to 96% in 2005/06.

During the summer of 2005, the level of customer contacts increased significantly due to a high number of incidents and due to increased vandalism of fire hydrants. This caused a significant deterioration in our call answering performance, which then recovered again later in the year.

We have continued with our programme of community and stakeholder engagement on a wide number of issues.

Our water resources remain secure and are forecast to meet demand in 2006/07.

### Value

We successfully delivered our services within the available finances from customer revenue and borrowings from the Scottish Executive, and we met all the financial objectives set by Scottish Ministers.

We continued our focus on improving operating efficiency by driving a further reduction in operating costs and we out-performed the WIC target of £265m by £6million.

We continued delivery of our capital programme in 2005/06 with investments including:

- £633.2 million in the delivery of the Quality and Standards II regulatory capital programme;
- £3.6 million on Q&SIII Programme Development;
- £13.4 million in the Q&SIII Start Early programme; and
- £9.4 million was invested as part of the Spend to Save programme.

Further progress was made with the agreed outputs, with the Water First Time Provision and Water Pressure programmes being completed during 2005-06. The mains and sewer rehab programmes have delivered 2990km and 390km of rehabilitation respectively in 2002-06.

A planned series of initiatives focusing on credit management, customer data, and customer issue resolution has been implemented and resulted in a significant reduction in both total and aged debt during the year. These will continue in 2006/07 and be supplemented by a number of new initiatives.

### **Compliance**

Overall regulatory compliance with drinking water quality standards improved to 99.64% in 2005 from 99.57% in 2004 and shows continued improvement since 2002.

Compliance results for bathing waters in 2005/06 showed that there were 2 bathing waters failing to meet the required standards as a result of Scottish Water discharges – an increase of 1 from 2004/05.

For 2005 the compliance with Look up Table standards, which is one of the measures used by Ofwat for company performance comparison, was 44 works failing. At the end of the financial year (March 2006) the number of failing works had reduced to 35 outperforming the Ministerial target of 45.

### **Board Changes**

During the year two changes have occurred to the Board, including the appointment of a new Chair who brings extensive experience from both within and outside the industry. One Non-Executive Member also resigned from the Board on 31 March 2006.

### **Key areas to be noted**

#### ***Confidence Grades***

To supplement the governance arrangements already in place for the Annual Return process that provide a high degree of scrutiny and assurance to the data submitted to WIC, we have carried out additional audits in this reporting year:

- Confidence Grades Audit - During January/February 2006 an audit was carried out by Regulation & Strategy on all confidence grades submitted in the June 2005 Annual Return to determine their appropriateness, especially in light of the WIC Reporter's audit findings. This resulted in a down grading of the confidence grades on much of the asset related data.
- Reporter's Findings - As with previous Annual Returns, the WIC Reporter produced detailed comments and suggestions/recommendations about the data we returned to WIC. This was presented to Scottish Water's Regulatory management Group in August 2005 for information and action.
- Briefings – briefings were given to all Directors, General Managers and Managers in December 2005, highlighting the responsibilities of all persons providing or approving regulatory information for submissions.

- Internal Audit - Internal Audit have also carried out a review of regulatory reporting, including reviewing the actions taken on Reporter's comments and the setting up of the new Information, Data & Reporting function.

### ***DMA Coverage***

Scottish Water has exceeded its target of achieving 60% DMA coverage by 31 March 2006, with coverage of 63.1% being reported.

This Return shows a slight decrease in our District Meter Area (DMA) coverage across Scotland compared to our figure reported in 2004/05. This is due to data quality improvements which have included merging data from the Scottish Water and Scottish Water Solutions data reporting tools, such that the majority is now reported from one source.

### ***Sewer flooding caused by 'other causes'***

Our reported level of sewer flooding caused by 'other causes' shows a significant increase over the figure reported in 2004/05, which we had noted was potentially under-reporting.

As mentioned in our Delivery Plan submission, we believe that the actual level of sewer flooding caused by 'other causes' is much higher than captured in our corporate system and, through a detailed sample survey and analysis, we have derived a figure of 688 (line B3.7) compared to 331 reported in 2004/05. We have lowered the confidence grade to C5 to reflect the uncertainty that remains about this data

It is important to note that there is no evidence that there has been any actual deterioration in level of service on sewer flooding to Customers, rather it is a change in the reported performance. Scottish Water has notified the change in reported performance to the Reporter as part of the audit process and all of the information used to derive this year's figures has been passed to the Reporter for scrutiny. This has resulted in a reduction in score of 15 points in this component of the OPA for 2005/06.

Work to improve the data capture, systems and processes for sewer flooding information forms one of the early tasks of the new Information, Data and Reporting group that has been created in Scottish Water's restructure of May 2006. That group is charged with making material improvements to the robustness and confidence in the sewer flooding information.

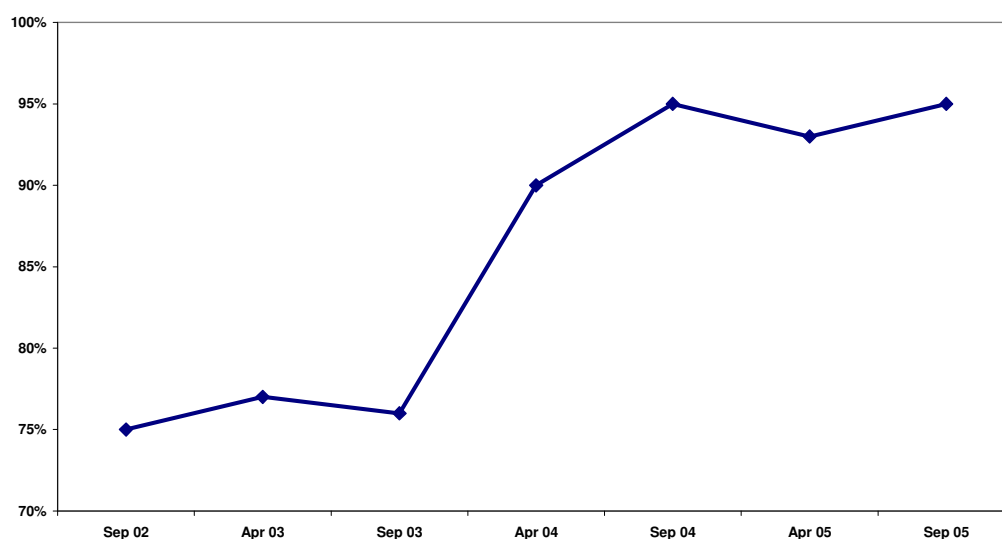
## 2. Key Outputs and Service Delivery

### 2.1 Service outputs and performance

#### Customer service satisfaction

We closely monitor the needs, expectations and experiences of our customers and our Customer satisfaction continues to improve. This is measured independently twice a year through a survey of a random sample of the Scottish household population. Satisfaction has risen from 75% in September 2002 to 95% in September 2005 as shown in the graph below. Scottish Water has been consistently performing at above 90% since April 2004.

**Household Bespoke Survey**



#### Levels of service indicators

Indicator	Units	2004/05	2005-06	Change in year
DG2: Properties at risk of low pressure		0.48	0.53	↑
DG3: Properties subject to unplanned interruptions of 12 hours or more		0.37	0.29	↓
DG5 Properties subject to sewer flooding incidents		0.022	0.032	↑
DG5 Properties at risk of sewer flooding once in 10 years		0.024	0.024	↔
DG5 Properties at risk of sewer flooding twice in 10 years		0.033	0.028	↓
DG6 Billing contacts responded to within 10 days		96.3	98.5	↑
DG7 Written complaints responded to within 10 days		99.6	99.8	↑
DG9 Telephone calls answered within 30 seconds		91.7	87.0	↓

## **DG2 Properties at risk of low pressure**

As we indicated in our 2<sup>nd</sup> Draft Business Plan, in 2005/06, the number of properties receiving low pressure increased from 11,839 to 12,995 or 0.53% of connected properties because of better data. Additional properties have been added based on figures contained in Level 1 DMA reports developed as part of the Capital Investment Programme. Additional properties were also added from the pilot test of the corporate low pressure register.

## **DG3 Supply interruptions**

Our performance on DG3, the number of properties subject to unplanned interruptions of 12 hours or more improved from 9,103 in 2004/05 to 7,259 in 2005/06. However, we have lower confidence in these figures due to process problems with data recording throughout the year. This is explained in detail in the commentary for Table B2.

## **DG5 Flooding from sewers**

The number of properties subject to sewer flooding incidents has risen from 512 in 2004/05 to 752 in 2005/06. However, we have low confidence in these figures due to process and system problems with data recording throughout the year. This is explained in detail in the commentary for Table B3.

Our performance on the total number of properties at risk of flooding from sewers improved from 1,343 in 2004/05 to 1,230 or 0.052% of connected properties in 2005/06. This improvement is due to company action both in the removal of properties through the Q&SII Capital Investment Programme and through better information gathered during a customer surveys pilot study.

## **DG6 Billing contacts**

In 2005/06 Scottish Water received 215,300 billing contacts of which 212,008 or 98.5% were responded to within 10 days, a 2.2% increase in performance compared with 2004/05. This improved performance is a result of increased efficiency of the Business Contacts Team, who aim to reduce the number of repeat contacts received by resolving each enquiry at the point of contact, thereby reducing the length of time taken to action or respond to each enquiry.

## **DG7 Written complaints**

The number of written complaints received in 2005/06 was 7,108, a decrease of 1,725 compared to the number received in 2004/05. Our performance on the number of complaints answered in 10 working days remains high at 99.8%. The drive by the Customer Contact Centre to resolve each complaint at the point of contact has been the main reason for this reduction in written complaints.

## **DG9 Ease of telephone contact**

In 2005/06, Scottish Water received 919,293 calls in office hours of which 799,413 or 87% were answered within 30 seconds. This is a decline in performance when compared to 2004/05 and is attributed primarily to the high volume of calls received in the summer of 2005 as a result of sustained fire hydrant vandalism and major incidents.

We have put in place additional call handling capacity to deal with these peaks if they arise in future.

## **Overall Performance Assessment (OPA)**

In 2004-05 Scottish Water's OPA score was 177 and this has decreased to 165 in 2005-06. The net reduction of 12 points reflects a net performance improvement across 11 OPA measures of 6 points, offset by a 18 point reduction in our reported performance, due to data cleansing, rather than an actual deterioration in level of service to Customers on the measures below:

- DG2 - % of properties subject to inadequate water pressure; and
- DG5 - % of connected properties suffering sewer flooding caused by other causes.

## **2.2 Drinking Water Service**

### **Compliance**

#### **Water quality compliance**

##### **Overall water quality compliance**

Overall compliance with water quality standards remained high in 2005, with 99.64% of all water quality tests conducted in our sampling programme complying with quality standards (2004: 99.57%).

##### **Microbiological quality**

Microbiological standards apply to water leaving treatment works, in service reservoirs and supplied at customer's taps.

###### **a) water leaving treatment works**

During 2005, 33,623 samples were taken for total and faecal coliform analysis. Compliance with total coliforms standards was 99.61% and with faecal coliform standards was 99.85%.

###### **b) water in service reservoirs**

56,408 samples were taken for total and faecal coliform analysis in 2005. Compliance with total coliform standards was 99.60% and with faecal coliform standards was 99.94%.

###### **c) water at customers' taps**

14,257 samples were taken at customers' taps for total and faecal coliform analysis in 2005. Compliance with the total coliform standards was 99.03% and for faecal coliform standards was 99.85%.

The following summary table highlights performance in water quality for microbiological quality from 2002 to 2005 based on regulation samples:



**Table 3.1: Microbiological quality of water**

		2002 fails	2002 compliance	2003 fails	2003 compliance	2004 fails	2004 compliance	2005 fails	2005 compliance
Treatment Works	Coliforms	131	99.67%	108	99.69%	118	99.66%	130	99.61%
	Faecal Coliforms	75	99.81%	59	99.83%	55	99.84%	57	99.85%
Service Reservoirs	Coliforms	403	99.31%	244	99.57%	327	99.42%	224	99.60%
	Faecal Coliforms	94	99.84%	47	99.92%	73	99.87%	35	99.94%
Customer Taps	Coliforms	204	98.75%	135	99.14%	123	99.12%	138	99.03%
	Faecal Coliforms	29	99.82%	24	99.85%	18	99.87%	21	99.85%

**Chemical sampling**

Physical and chemical standards apply to water supplied at customers' taps. During 2005, 117,702 tests were carried out for these parameters. Of these 99.58% complied with the regulatory standards.

The following summary table highlights the performance of the key chemical parameters for 2002 to 2005.

**Table 3.2: Chemical quality of water**

	2002 fails	2002 compliance	2003 fails	2003 compliance	2004 fails	2004 compliance	2005 fails	2005 compliance
THM Total	575	82.90%	478	85.54%	131	92.58%	101	94.20%
Iron	261	96.03%	233	94.64%	127	97.49%	79	98.52%
Colour	151	95.63%	121	96.20%	165	96.74%	81	98.49%
Manganese	36	99.06%	53	98.49%	62	98.77%	44	99.18%
Aluminium	35	99.18%	39	98.82%	27	99.46%	33	99.38%

## **Progress on delivery of Q&SII enhancement programme**

Within this programme, water quality improvements are being delivered via a number of routes, including construction of new treatment works, upgrading of existing processes, water main replacement and extension of existing mains networks to allow the closure of some small treatment works. 78% of WQ outputs have been delivered.

57 water quality driven projects are continuing to be delivered after March 2006.

Construction of the new £122m water treatment works at Milngavie, to supply Greater Glasgow is progressing well. This works is being designed to supply 240 megalitres per day. This together with the additional 150 megalitres per day to be supplied from Balmore Water Treatment Works will bring significant improvements in water quality to our Greater Glasgow customers. The new supply will be introduced in December 2007.

During the 2002-06 period we have successfully delivered investment to address 192 water quality undertakings through 95 projects. These include either replacement of or improvements to existing treatment works, or supplying communities through extension of the mains network from adjacent zones. Further investment to deliver a further 42 undertakings is programmed for delivery in 2006-07. A number of water quality undertakings have been deferred to Q&SIII as part of the quality substitutions process.

## **2.3 Wastewater Service**

### **Compliance**

#### **Wastewater Treatment**

SEPA authorise discharges to the aquatic environment by means of consents issued under the Control of Pollution Act (COPA) and report compliance with WWTW consent conditions based on the audit monitoring that they carry out. SEPA report on compliance in its annual report based on the results for the calendar year. This year Scottish Water is reporting compliance based on the calendar year to match with SEPA.

Scottish Water has worked closely with SEPA throughout the year to improve compliance reporting. As a result of this, SEPA has moved to monthly rolling compliance and reports 'Look up Table' compliance and overall compliance. This allows Scottish Water to report compliance in a manner similar to England and Wales. For 2005 the compliance with Look up Table standards, which is one of the measures used by Ofwat for company performance comparison, was 44 works failing. At the end of the financial year (March 2006) the number of failing works had reduced to 35 outperforming the Ministerial target of 45.

### **Bathing Waters**

During the 2005 bathing season there were two failing bathing waters of the fifty five bathing waters that can be impacted by Scottish Water's discharges. The failures were at Stonehaven and Nairn.

The bathing water results in 2005 were, yet again, very good for Scotland. For the mandatory standard:-

52 of the 55 bathing waters that can be impacted by Scottish Water Assets complied with the coliform standards. There is ongoing discussion between SEPA and Scottish Water to ascertain whether the failure at Eyemouth can be attributed to Scottish Water.

## Progress on environmental compliance

### Environmental Directives

The tables below report the actual and forecast agreed WIC 18 project delivery performance in relation to the Environmental Legislative Compliance dates.

Environmental Compliance Performance- UCSO's								
Projects	a) Delivered to Date	b) Up to 3 months late	c) Up to 6 months late	d) Up to 9 months late	e) Up to 12 months late	f) Up to 24 months late	g) > 24 months late	Grand Total
Sum of UCSO projects	247	3	4	1	6	4	0	265
Environmental Compliance Performance- Wastewater Treatment								
Total	a) Delivered to Date	b) up to 3 months late	c) up to 6 months late	d) up to 9 months late	e) up to 24 months late	f) up to 48 months late	g) > 48 months late	Grand Total
UWWTD	284	13	27	6	25	4	0	359
Bathing	9	0	0	0	0	4	0	13
Shellfish	18	3	2	2	2	0	0	27
Fisheries	10	3	1	1	1	0	0	16
COPA	64	9	5	4	5	0	1	88
Other	13	0	0	0	0	0	0	13
Sum of WW-C projects	398	28	35	13	33	8	1	516

### UWWTD

There are a number of projects that are greater than six months late, including Dunoon, Tayport, Stonehaven and Invergordon (subject to delay due to planning issues) and Tobermory and Bowmore (delayed due to agreeing proposals to deal with the distilleries).

### Shellfish

Projects around Loch Ryan have been removed from Quality & Standards II and are being reworked to meet SEPA's new requirements for the shellfish water.

## 2.4 Progress on Q&SII Capital Investment Programme

### Q&SII OUTPUT DELIVERY

The outputs delivered to date against the WIC18 Ver 3.5 baseline targets<sup>1</sup>, are detailed in the table below which shows that overall 86% of Q&SII outputs have been delivered to end of March 2006. 283 projects within the Quality programmes obtained sign-off from the Quality Regulators by March 2006.

Q&SII PROGRAMME			Delivered Outputs to End March 2006	% To date	WIC18 Target
DW – FT	Properties receiving FT provision of water	nr	407	100%	408
DW – P	Removal of properties from the poor pressure register	nr	1391	100%	1391
DW – WQ	Drinking Water drivers addressed	nr	471	78%	604
WM – R	Mains rehabilitated	km	2990	98%	3051
WW – C	Continuous discharges removed	nr	416	70%	591
WW – FR	Removal of properties from 'at risk' flooding register	nr	728	88%	829
WW – FT	Properties receiving FT provision of sewerage	nr	377	57%	667
WW – R	Sewers rehabilitated	km	390	95%	409
WW – UCSO	UCSO's removed	nr	383	89%	429
			Overall	86%	

The WW-FT target reflects the number of properties which it is believed can be delivered within reasonable cost.

A significant risk to delivery of the remainder of the capital programme remains the achievement of planning approvals and obtaining agreement from Regulators on substitutions to determine scope at a number of locations.

### Q&SII PHASING

The current estimate of the overhang investment is a net £283 million at end of March 2006 based on programme of £288 million less £5 million of contributions from third parties to enable development.

The overhang includes additional obligations in respect of the DSEAR legislative requirements, enhanced security provision and projects delayed by the substitution process, in addition to completion of the Q&SII programmes. Funding currently held within the Environmental Substitutions requires confirmation of where it is to be applied to enable the

<sup>1</sup> with adjustments for further changes agreed with the Quality Regulators thereafter

projects to progress. The overhang also includes provision for completion projects to address WQ Undertakings which have not been discharged by the original quality projects.

## 2.5 Occupational Health and Safety

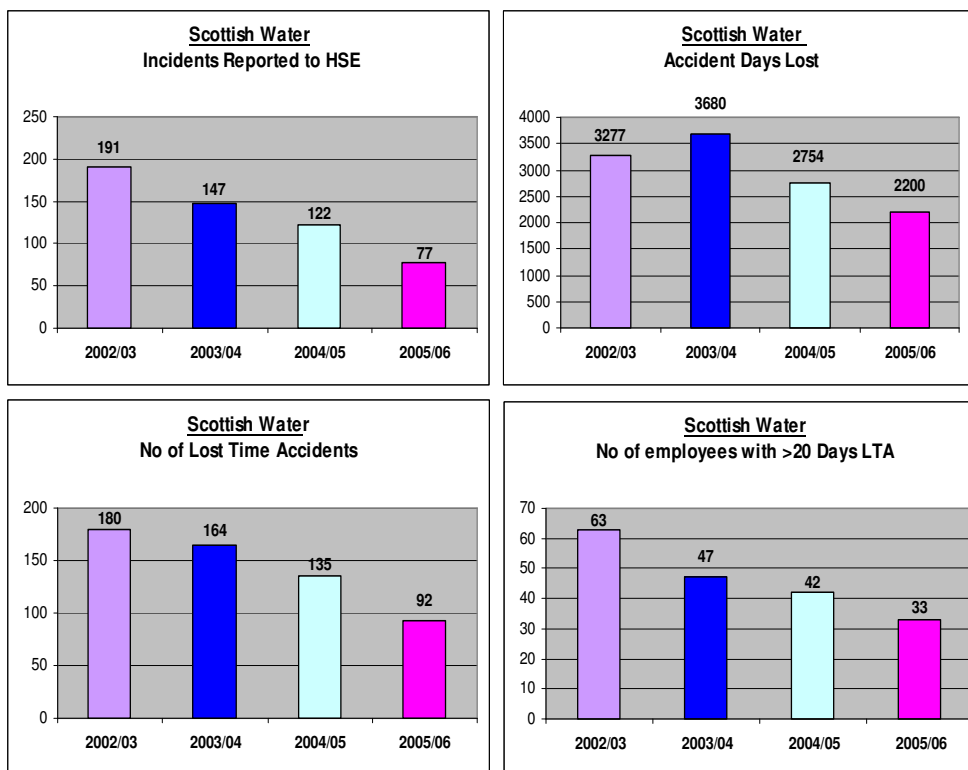
### Health and Safety Performance

Scottish Water is committed to continuous improvement in Occupational Health and Safety (OH&S) performance. On an annual basis we use a comprehensive action plan, our “Annual Statement of Intent” to target key improvement areas. OH&S is also assessed by an independent audit as part of our ‘annual letter of assurance’ process.

Performance has improved significantly year on year for a range of health and safety parameters. In particular, during the last financial year we have achieved:

- 37% reduction in the number of incidents reported to the HSE
- 19% reduction in the number of non-reportable incidents
- 32% reduction in the number of lost time accidents
- 20% reduction in the number days lost due to accidents
- 21% reduction in the number of long-term absences due to accidents

Our OH&S performance over the last 4 years can be summarised as follows:



Scottish Water has implemented a robust Health and Safety Management System, as part of the business planning process, a comprehensive Health and Safety Action plan is produced annually. An OH&S Paper updating on progress is submitted to Scottish Water’s Board and cascaded to Managers and Trade Unions on a monthly basis.

Scottish Water's improvements were recognised externally, when the Health and Safety Executive awarded us the Overall National Winner Award for the European Health and Safety Week in 2003.

While we can demonstrate that Scottish Water's health and safety performance has significantly improved, it is recognised there is still much to be done.

### 3. Expenditure and Financial Performance

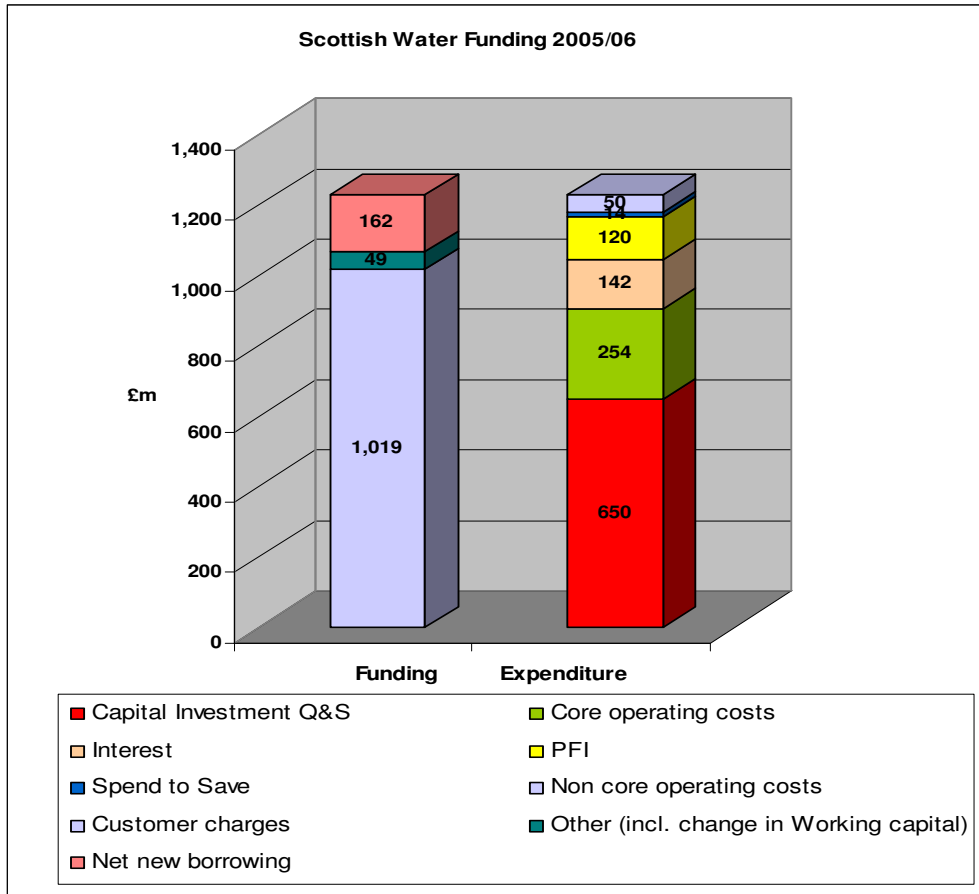
#### Financial results

The financial statements reflect the full implementation of Financial Reporting Standard No 17 "Retirement Benefits" (FRS 17), with the results for 2004/05 restated accordingly.

£'M	2005/06	2004/05	Variance
<b>Turnover</b>	<b>1,019.0</b>	<b>960.5</b>	<b>-58.5</b>
Operating Costs	423.7	420.3	-3.3
Depreciation	251.6	260.3	8.7
Gain on Sale of Assets	-3.9	-9.4	-5.6
FRS17 Adjustment	2.8	5.3	2.5
<b>Operating Surplus before Exceptional Items</b>	<b>344.8</b>	<b>284.0</b>	<b>-60.8</b>
Exceptional Items	4.9	61.8	56.9
<b>Operating Surplus before Interest</b>	<b>339.9</b>	<b>222.2</b>	<b>-117.7</b>
FRS17 Adjustment -Finance adjustment	1.0	3.4	2.4
Net Interest	142.8	136.1	-6.7
Taxation Charge	61.3	27.1	-34.2
<b>Profit after tax</b>	<b>134.8</b>	<b>55.6</b>	<b>-79.2</b>

#### Financial Performance

The graph below highlights the key sources of funding and how these were applied to Scottish Water's activities. All of the revenue raised from customers, together with £162.1 million of net new loans, was used to finance Scottish Water's operational activities and capital investment programme. The surplus before tax of £196.1 million was fully reinvested in the business to enable the delivery of the capital investment programme.



## Turnover

Total turnover for the year increased by 6.1% to £1,019.0 million. Turnover from core water and wastewater services supplied to household customers increased by 3.6% to £628.3 million driven mainly by the tariff increase effective from 1 April 2005. Turnover from services supplied to business customers increased by 6.7% to £334.6 million due to tariff increases and that in 2004/05 a prudent view of income generation was taken due to the significant data cleansing activity that was taking place on the new billing system.

The proportion of core business turnover (£973.0 million) derived from household customers has now increased to 65% in the year ended 31 March 2006 compared to 58% in the year ended 31 March 2002, the final year of the former Water Authorities.

Turnover from the provision of non-core services, provided traditionally by the former water authorities, declined by 17.9% to £10.1 million.

Scottish Water's new trading activities relate primarily to the sale of contracting services to Scottish Water Solutions and the provision of water-related services to major business customers. Turnover from those activities increased from £28.4 million in 2004/05 to £46.0 million in 2005/06. £32.8 million (2004/05 - £21.7 million) of this income relates to mains rehabilitation and other capital investment activities carried out on a commercial basis by Scottish Water's contracting division for Scottish Water Solutions Limited.

The nature of the contractual agreement between Scottish Water and the other shareholders in Scottish Water Solutions Limited is such that the parties are engaged in joint activities that

do not constitute an entity carrying on a trade or business in its own right. Consequently, Scottish Water Solutions Limited, has been accounted for under FRS 9 Associates and Joint Ventures as a JANE (Joint Arrangement Non Entity). On this basis Scottish Water accounts directly for its own gross assets, liabilities and cash flows in the joint arrangement thus dispensing with the need for Group Accounts. Consequently, the trading income for sales to Scottish Water Solutions Limited is included in turnover and associated costs within cost of sales.

An analysis of turnover by customer type is summarised below:

	2005/06	2004/05	Change
	£m	£m	%
Household	628.3	606.2	3.6
Commercial	334.6	313.6	6.7
Non statutory services	10.1	12.3	(17.9)
<b>Total Core Turnover</b>	<b>973.0</b>	<b>932.1</b>	<b>4.4</b>
Other trading activities	46.0	28.4	62.0
<b>Total Turnover</b>	<b>1,019.0</b>	<b>960.5</b>	<b>6.1</b>

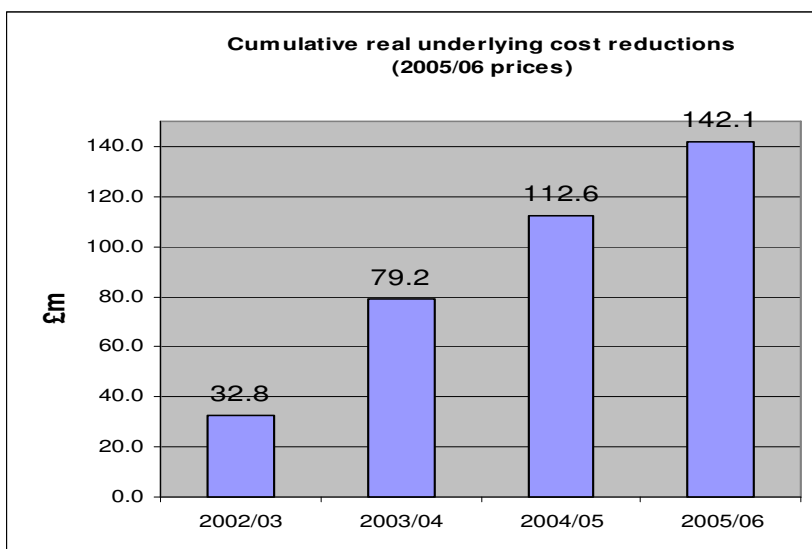
### Operating costs

Total reported costs reduced by £2.3m to £674.2m (reductions of £0.5m cost of sales and £1.8m administration costs) but this is after absorbing increased costs of new trading activities of £16.6m and reduced gains on asset sales of £5.5m. Excluding these two items costs reduced by £24.4m or 3.7%.

From a Regulatory cost perspective, nominal operating costs (i.e. excluding depreciation, PFI charges, FRS 17 pension charges and costs associated with new trading activities) reduced by £20.5 million to £259.0 million compared to £279.5 million in 2004/05. Continued focus on improving operating efficiency has driven this reduction in operating costs, out-performing by £6 million the target of £265 million, set by the former Water Industry Commissioner.

Real underlying operating costs, when compared to the similar costs of the three former water authorities in 2001/02 (i.e. excluding new operating costs associated with newly commissioned plant and the impact of FRS 17), have reduced by £142.1 million or 36% since the creation of Scottish Water as depicted in the graph below. However, when the cost base is adjusted to reflect cost increases beyond management control i.e. regulatory and local authority rates charges, the underlying operating cost reduction in the first four years of Scottish Water increases to 41%.





The cost of the PFI schemes in the year was £120.1 million, £7.4 million higher than in 2004/05. Contractual inflation accounted for £2.5 million of the increase with the remainder due primarily to the impact of a one-off provision release in 2004/05 associated with resolution of contractual claims.

Depreciation, including infrastructure depreciation, reduced by £8.7 million to £251.6 million because of a reduction in the assessed long term cost of maintaining the infrastructure assets.

### Exceptional costs

Exceptional costs charged in the year totalled £4.9 million (2005 - £61.8 million) and related to restructuring and transformation costs undertaken as the final part of the £200 million 'Spend to Save' programme. This programme was for a discrete category of expenditure up to 2005-06 to cover one-off transformation and restructuring costs that would contribute to the reduction of future annual operating costs.

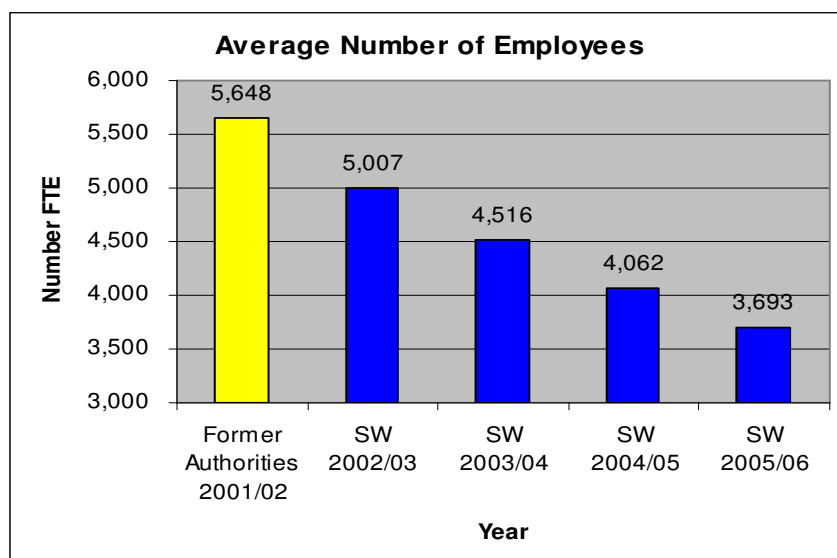
An analysis of the total "spend to save" expenditure of £199.9 million over the four years from 2002/03 is set out in the table below.

	2002/03	2003/04	2004/05	2005/06	Cumulative total
	£m	£m	£m	£m	£m
Business transformation	15.3	18.8	20.4	6.6	61.1
Staff severance costs	9.3	34.1	41.4	-1.7	83.1
<b>Total charged to income and expenditure account</b>	<b>24.6</b>	<b>52.9</b>	<b>61.8</b>	<b>4.9</b>	<b>144.2</b>
New capital investment to improve efficiency *	15.3	21.7	9.3	9.4	55.7
<b>Total</b>	<b>39.9</b>	<b>74.6</b>	<b>71.1</b>	<b>14.3</b>	<b>199.9</b>

\* Costs for 2003/04 and 2004/05 have been revised to reflect corrections in classification between spend-to-save capital investment and the Quality and Standards 2 capital investment programme. Consequently, expenditure increased by £0.2 million in 2003/04 and increased by £1.8 million in 2004/05.

By effective use of the employee voluntary severance scheme, the average number of employees during the year reduced by 369, or 9%, to 3,693. Compared with the average level employed by the former water authorities in 2001/2 this equates to a reduction of 1,955 or 35% in the first four years of Scottish Water.

The number of people employed at the end of the year, after taking account of 73 leavers on 31 March, reduced to 3,557. The table below shows the average number of employees compared with the final year of the three former water authorities.



2001/02 is the total for the three former water authorities.

### Finance costs

During the year, net debt increased by £168.9 million to £2,436.2 million. The increase was driven by £232.9 million of new long-term loans at a weighted average interest cost of 4.2%, partially offset by a £70.9 million repayment of long-term loans, a £0.1 million net increase in short-term loans and a £6.8 million reduction in cash balances.

At 31 March 2006, the weighted average interest cost of the £2,436.9 million outstanding debt was 6.00% (2005- 6.24%). Net interest payable during the year was £142.8 million, £6.7 million higher than in 2005/06. Interest cover, based on cash generated before capital expenditure, increased from 3.1 in 2004/05 to 3.4 in 2005/06.

### Taxation

The tax charge on the income and expenditure account was £61.3 million, (2005 - £27.1 million). The effective rate was 31.3%, (2005 restated- 32.8%) in respect of deferred taxation; no corporation tax is payable. This is higher than the UK Corporation tax rate of 30% due to adjustments associated with timing differences and disallowed costs. Excluding the impact of FRS 17 the effective tax rate was 30.6% (2005-29.6%).

## Customer debt

Amounts owed by our business customers have reduced significantly over the past four years. The graph below highlights the major reductions in total debt, from an inherited position of £112.2 million to £49.7 million as at 31 March 2006, a reduction of 55.7%.



## Compliance with Government Financial Targets

### Sufficiency of revenue

Scottish Water is required to cover costs with revenue one year with another. Scottish Water reported a surplus before tax of £196.1 million for the year.

### Borrowing Limit

For 2005/06 Scottish Ministers set Scottish Water's maximum net new borrowing limit at £170.0 million. Actual net new borrowings were £162.1 million.

## 4. Pressures on costs

Some of the debate during the recent price review process focused on uncertainties around future costs. The Commission indicated areas that would be outside management control within the final determination including capital inflation and price increase caused by regulatory settlements for electricity (to the extent not captured in inflation indices).

We are already gathering information about some of the new cost pressures and we will continue to monitor information about the new cost pressures.

We expect to incur extra operating costs outwith our control in the next four years. These costs would include:

- Local Authority rates
- pensions
- SEPA charges

- Chemical prices
- Fuel
- Sludge disposal

## 5. Efficiencies

### Opex Efficiency Analysis

Scottish Water's efficiency position has been estimated using Ofwat's 2004/05 opex models<sup>2</sup> based on 2004/05 data from companies in England and Wales.

Scottish Water's modelled opex in 2005/06 was £214.1 million compared with £227.2 million predicted by the models. Once the adjustments are made to the residuals<sup>3</sup>, these models indicate that Scottish Water operated at £11.8million below predicted; the water service at £12.3m below predicted (band B) and the wastewater service at £0.5m above predicted (band C).

The efficiency position has improved by £23.7 million since 2004/05. This puts Scottish Water within the pack of English and Welsh companies.

## 6. Key Supporting Information

### Water Resources, Supply and Demand

This year, we submitted our first Water Resource Plan (WRP) to SEPA. In preparing the plan, methodologies for producing the data and for addressing longer term data improvements, were agreed with SEPA and the data improvements have been incorporated into this Return. The most significant changes have involved redefining Water Resource Area (WRA) boundaries, especially in the Central Scotland area and this is explained further in the commentary. The number of WRAs this year has reduced from 255 to 240.

This year we are reporting a greater population in areas with headroom >5% (2,919,730 in 05/06 compared to 2,598,670 in 04/05) and a corresponding reduction in the population with headroom <5%.

This year we have continued to provide unconstrained services with 0% of the population affected by hosepipe restrictions.

### Procurement

In 2005/06, Scottish Water Solutions (SWS) delivered a record investment of £468m, a 28% increase on the previous year. This brings the total invested since SWS was formed two and a half years ago to over £850m.

## 7. Competition

<sup>2</sup> Ofwat Report: Water and sewerage service unit costs and relative efficiency, 2004-05 report, Appendix 1: Econometric Models. All figures quoted in this section are in 2005/06 prices. These models have not been adjusted to allow for the expected 2% annual efficiency improvement over 2005/06. Actual opex excludes terminal pumping costs of £0.173m 2005/06 and £0.162m 2004/05. The Ofwat models do not split wastewater treatment works between bands 0 and 1 therefore the band 1 predicted unit cost has been applied to both bands 0 and 1.

<sup>3</sup> The residuals are reduced by 10% (water) and 20% (wastewater).

Further to the Water Services etc (Scotland) Act 2005, we have been preparing for the introduction of retail competition into the Scottish water industry. Scottish Water Business Stream was established on 1 April 2006 and preparations are being made for the opening of the retail market in April 2008. We have been working closely with the Water Industry Commission for Scotland to develop policies, procedures and licensing arrangements and have set up two new functions to progress both retail and wholesaler activities. Further work is ongoing in terms of finalising the Operational Code of Practice and preparing for the arrival of retail competition.

We are continuing to work with the Commission in the development of the market framework and look forward to participating in the Licensing Framework Implementation Group.

## **8. Other Issues**

### **Board changes**

There have been two changes to Scottish Water's Board during the report year. Scottish Water's Chair, Alan Alexander resigned on 20 February 2006 and has now been replaced by an interim Chair, Ronnie Mercer. One Non-Executive Member, Mr. Bill Cameron, also resigned, on 31 March 2006 from the Board.

### **Leakage**

In this return we are reporting our estimated level of leakage at 1104ML/day.

This year's estimate indicates a further reduction in leakage as a result of pressure management and mains rehabilitation carried out since 2003/04.

We anticipate Board agreement to the leakage targets proposed by the Water Industry Commission in their letter of 10th May and we expect to meet these targets through our newly defined focus on pro-active leakage management. We welcome the additional funding within the Final Determination to achieve the leakage reduction.

We will be appointing experienced Leakage Delivery and Leakage Strategy Managers in 2006. We will be allocating clear internal responsibilities for delivering target leakage reductions and maintenance thereafter.

We will increase our DMA coverage from 62% to 96% of connected properties by end of March 2008.

### **Asset Revaluation**

We have undertaken work to review the differences between MEAV and EARC valuations of the asset base and the issues associated with the existing asset inventory and the current method of valuing the asset base.

The asset inventory is the main building block of many systems within Scottish Water. The view held by the Commission, supported by the Reporter, and acknowledged by Scottish Water is that asset inventory, particularly in relation to non-infrastructure assets, lacks accurate data.

We are now instigating a feasibility study to identify, in detail, the extent of the work required to complete the asset revaluation. It is expected that the feasibility study will be completed by December 2006.

We wish to involve the Commission and the Reporter in the scoping of the project to ensure that the output meets the requirements of all stakeholders.

### **Looking forward**

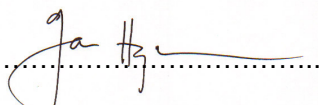
During 2005/06, Scottish Water produced its Draft Business Plans to allow the Commission to produce its Final Determination on the Strategic Review of Charges for 2006-2010. Scottish Water's Delivery Plan to implement the requirements of the Final Determination has now been approved by the Minister.

Following the Final Determination we are completing a reorganisation of the business and are initiating a number of key strategic projects which will contribute to meeting the challenging targets for the next four years.

More information is contained within our delivery plan at [www.scottishwater.co.uk](http://www.scottishwater.co.uk).

### **Governance**

The methodologies used for producing the detailed information in Scottish Water's 2005/06 Annual Return to the Water Industry Commission (WIC) have been further enhanced this year to ensure robust reporting of data and to show data sources, calculations, assumptions and dependencies. This approach, along with the formal audits carried out by the Regulatory Reporters has ensured that this submission is based on sound processes. The governance of the production of this Return has improved through increased project management and governance processes this year.

Signed.......... Date...16 June 2006

Jon Hargreaves, Chief Executive, Scottish Water