

# Annual Return 2006/07

## Overview

### DOCUMENT CONTROL

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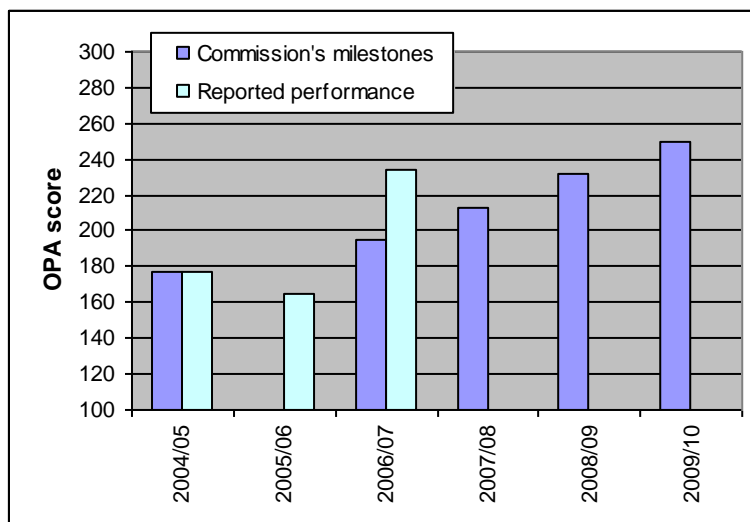
# 1. Executive Summary

This overview document reports on our performance and activities in 2006/07, the first year of the 2006-10 period. We are pleased with the good start we have made addressing the challenges we took on when accepting the final determination of the 2006 price review, in particular in OPA performance.

In 2006/07 we have made significant improvements in customer service, information processes and efficiency. Our principal achievements in 2006/07 are highlighted below.

## Overall Performance Assessment (OPA)

We accepted the Commission's target of 250 for OPA by 2009/10 as part of the Final Determination and we have initiated a major programme to improve performance in most of the thirteen measures that comprise the OPA. That programme is already demonstrating good progress, with the score for 2006/07 of 229 showing a 38% improvement over the corresponding reported performance for 2005/06.



## Information

We have made a good start in 2006/07 in improving the completeness, availability, reliability, access to and reporting of information. This will enable us progressively to improve the confidence grades we report to the Commission and this year confidence grades have improved for the reporting of low pressure, interruptions to supply and sewer flooding.

The shortcomings we reported in 2005/06, when we were unable to report interruptions to supply in some parts of Scotland, or internal sewer flooding in any part of Scotland, have now been overcome.

We have achieved significant improvements in information in 2006/07 due to:

- improvements to our asset inventory, both non-infrastructure and infrastructure, including a major project to survey above ground sites;
- implementing new systems and processes to improve the completeness, consistency, and accuracy of field data, hence improving reliability; and
- improved reporting with all non-financial information being reported from a single department (IDR), using a single corporate data source where possible.

## **Investment**

### ***Overall Performance***

Scottish Water delivered £413m of investment in 2006/07. The 2006-07 outputs target of 98% for Q&SII has been met and outputs out-performance has been achieved on the Q&SIII year 1 Programme compared to our Delivery Plan.

The planned target for investment in 2007/08 presented in the refreshed Delivery Plan, approved by the Minister, is £610-650m for Q&SII and Q&SIII combined.

### ***Q&SII Programme 2006-07***

£173m of investment was delivered on the Q&SII Conclusion Programme. The forecast outturn for Q&SII is £2,189m including the overhang value of £294m net of contributions.

98% of Q&SII outputs had been delivered at the end of 2006/07. The remaining outputs are primarily associated with the removal of wastewater continuous discharges, the removal of unsatisfactory storm overflows and drinking water quality, with all other output requirements having been achieved. Scottish Water remains committed to closing out the Q&SII programme as quickly and efficiently as possible (however there are a few difficult projects).

## **Financials**

In 2006/07 we out-performed the original Delivery Plan agreed by Scottish Ministers and the Water Industry Commission for Scotland by £23.8m. We reported an HCA surplus before tax of £228.9 million for the year.

Scottish Ministers set our maximum net new borrowing limit at £20.0 million for 2006/07. Actual net new borrowings in 2006/07 were nil.

## **Leakage**

Our reported leakage for this report year is 1,004 MI/d, a 100MI/d (9%) reduction on our reported leakage in 2005/06 of 1,104 MI/d. However, we have not succeeded in meeting our interim leakage target for 2006/07 to reduce leakage to 960Mld.

A pro-active approach to establishing robust DMA coverage has moved us from 63.1% coverage in March 2006 to 70.5% by March 2007 and the ongoing project is on target to achieve more than 90% coverage of connected properties by the end of March 2008.

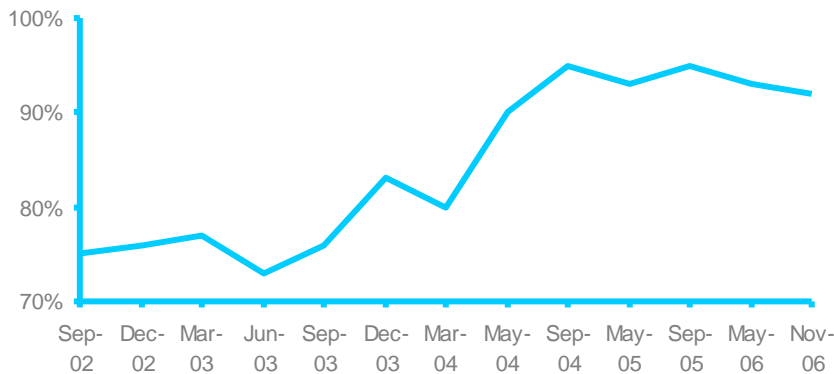
## **Other Customer Service measures**

There are two main measures of satisfaction that we use:

- Perceptions Survey
- Transactional Survey

## Perceptions Survey

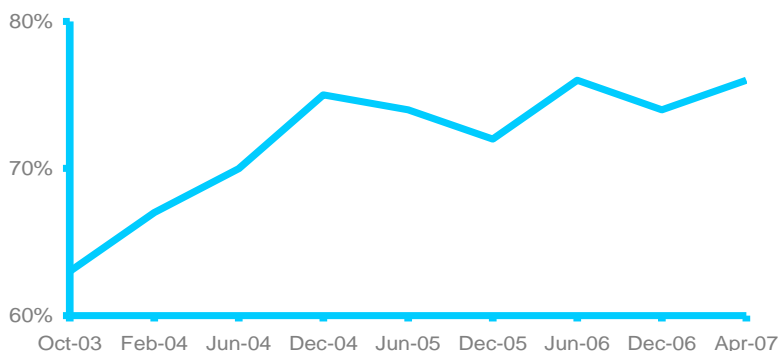
We closely monitor the needs, expectations and experiences of our customers. This is measured independently twice a year through a survey of a random sample of the Scottish household population. Satisfaction has risen from 75% in September 2002 to 92% in November 2006 as shown in the graph below. Scottish Water has been consistently performing at above 90% since April 2004.



## Transactional Survey

It is important that we continue to drive improvements in the experiences that we provide to our customers when they have to get in touch with us. In general, customers who have to get in touch with Scottish Water will have an issue which we should manage as quickly through to resolution while keeping them updated on our progress. We track our customers' satisfaction with how well we do this through this independently managed survey. The survey is carried out twice a year with 1,600 customers from our contact system. We have clear focus on the need to provide consistently positive experiences, and feedback from our customers indicate that they are increasingly satisfied with our services.

The graph below shows that despite a dip in performance during the Report year, Scottish Water has out-turned at 76% satisfaction and is continuing on an upward trend.



Our performance against our published guaranteed standards of service improved from 98% in 2005/06 to 99.7% in 2006/07. This compares with 91.4% at the formation of Scottish Water.

We again maintained unconstrained supplies to all our customers during the report year and our water resources remain secure and are forecast to meet demand in 2007/08.

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

## **Compliance**

Overall compliance with water quality standards continued to improve in 2006, with 99.76% of all water quality tests conducted in our sampling programme complying with quality standards (2005: 99.64%; 2004: 99.57%).

Compliance at customer's taps (used for calculation of OPA) improved to 99.65%, up from 99.55% in 2005.

During the 2006 bathing season, all of the 58 bathing waters that can be impacted by Scottish Water's discharges complied with the coliform standards i.e. 100% compliance. 2006 was the first year that all designated bathing waters in Scotland achieved at least the minimum EU Mandatory standard, and the number of designated bathing waters achieving the more stringent EU Guideline standard has been steadily increasing over the last three years with 39 (67%) achieving the guideline standard in 2006.

The final WWTW Compliance figures for 2006/07 have now been agreed with SEPA as 47 failing works against a target of no more than 44 failing works.

## **Board Changes**

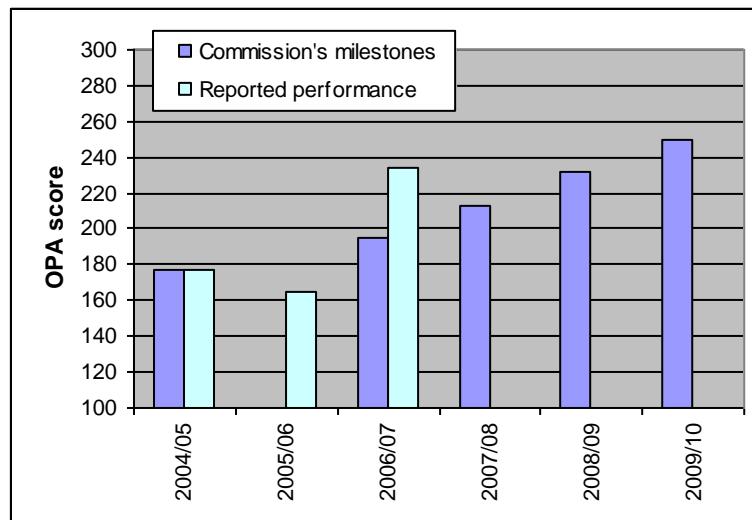
During the year two changes have occurred to the Board. Ronnie Mercer was appointed as Chair of Scottish Water in April 2006 and Cheryl Black, Customer Service Director resigned from the Board in November 2006. In addition, Mark Adderley (Director of Human Resources and Business Services) and Atholl Duncan (Director of Corporate Affairs) left the business during the year.

## 2. Key Outputs and Service Delivery

### 2.1 Service outputs and performance

#### Overall Performance Assessment (OPA)

We accepted the Commission's target of 250 for OPA by 2009/10 as part of the Final Determination and we have initiated a major programme to improve performance in most of the thirteen measures that comprise the OPA. That programme is already demonstrating good progress, with the score for 2006/07 of 229 showing a 38% improvement over the corresponding reported performance for 2005/06. We are on course to beat the 250 target for 2009/10.



The areas in which we made the biggest improvements in 2006/07 are:

- Properties subject to inadequate water pressure reduced from 12,995 (0.53% of properties) to 7,772 (0.31%);
- Reported leakage reduced from 1,104 MI/d to 1,004 MI/d (4.56% above target);
- Reported incidents of internal flooding due to blockages or failures of main sewers (other causes – i.e. other than through hydraulic overloading) reduced from 617 (0.026%) to 185 (0.008%);
- Percentage of customer billing contacts responded to within five days increased from 93.3% to 99.3%;
- Percentage of telephone calls answered within thirty seconds increased from 87.0% to 97.2%.

The table below shows our performance on each of the measures:

**Table 2.1: OPA Performance**

Indicator	2005/06 OPA performance	2006/07 OPA performance	2005/06 weighted OPA score	2006/07 weighted OPA score	Change
% of water samples that comply with parameters	99.55%	99.65%	37.4	40.2	2.7
% of properties subject to inadequate water pressure	0.53%	0.31%	3.8	16.4	12.6
Connected properties experiencing unplanned interruptions	1.76%	1.43%	18.4	22.3	3.9
Hosepipe restrictions	0	0	25.0	25.0	0.0
Leakage	-	4.56%	7.5	15.0	7.5
Number of incidents of sewer flooding caused by overloading of main sewers, as % of connected properties	0.00191%	0.00244%	24.7	24.4	-0.3
Number of incidents of sewer flooding from other causes on main sewers, as % of connected properties	0.02616%	0.00777%	7.7	33.2	25.5
Sewer flooding (properties at risk)	0.05215%	0.03244%	7.4	9.9	2.5
Sewage sludge disposal	0.00%	0.00%	12.5	12.5	0.0
% population equivalent served by non-compliant sewerage treatment works	21.81%	20.32%	5.0	5.0	0.0
% customer billing contacts responded to within 5 days	93.33%	99.29%	3.7	8.8	5.0
% written complaints responded to within 10 days	99.76%	98.73%	9.0	7.2	-1.7
% telephone calls answered within 30 seconds	86.96%	97.22%	3.1	8.9	5.8
			165.2	228.7	63.6

***Percentage of water samples that comply with parameters***

Our water quality performance is discussed in Section 2.2 below.

***Percentage of properties subject to inadequate water pressure***

During 2006/07 we have put in place new systems and processes to record properties that have reported inadequate water pressure. We now have, for the first time, a comprehensive, live corporate system with the address of every property in Scotland which has a historic report of inadequate pressure. Using this new system, we have targeted the zones with the most number of affected properties and performed detailed pressure measurement tests to confirm the current water pressure. This has enabled us to reduce the number of properties on the register from 12,995 to 7,772. The reduction results from a combination of better measurement of pressure and recent improvements to the water network that have increased pressure in certain areas.

***Connected properties experiencing unplanned interruptions***

Table 2.2 below shows the improvement in reducing the number of properties that experience unplanned interruptions. We have placed great emphasis on the speed of restoration following an unplanned interruption and our regional teams have demonstrated innovation and a strong focus on maximising the number of restorations that can be achieved in less than six hours.



**Table 2.2: Unplanned interruptions to supply**

	2005/06	2006/07
Properties interrupted for 6 to 12 hours	26,250	24,459
Properties interrupted for 12 to 24 hours	6,017	4,142
Properties interrupted for more than 24 hours	1,242	668
<b>Total number of properties interrupted for more than 6 hours</b>	<b>33,509</b>	<b>29,269</b>
<b>Total number of properties interrupted for more than 12 hours</b>	<b>7,259</b>	<b>4,810</b>

***Hosepipe restrictions***

We have not required any hosepipe restrictions since Scottish Water was formed in 2002. We do not expect to have to impose any such restrictions in 2007/08.

***Leakage***

We now have teams of over 100 people in both Planning and Customer Service that are dedicated to reducing reported leakage and to meeting the targets agreed with the Commission. In 2006/07, the target for leakage was 960MI/d. We have not met this target, but we did achieve a large reduction in reported leakage of 100MI/d to 1,004MI/d. The reduction brings us within 5% of the target.

The new methodology and data for calculating leakage have led to a reduction in reported leakage of about 57 MI/d. The remaining 43 MI/d of the reduction reported in 2006/07 arose from the actions of the leakage teams in finding leaks that were otherwise unreported and fixing them.

To derive the OPA score for 2006/07, we have considered only the 43 MI/d reduction which we can demonstrate as a reduction from the actions of the leakage teams. If that had been the only reduction we reported from last year's reported leakage, we would have reported leakage more than 10% above the target of 960 MI/d. That would have given rise to a score of 15 OPA points for 2006/07 and we have therefore included only this number in our total OPA score, rather than the 20 points that would have been included if we had recognised the reported position of being within 5% of the target.

***Number of incidents of sewer flooding caused by overloading of main sewers***

In 2006/07 there were 58 incidents of flooding from overloaded main sewers that caused internal flooding of customers' properties. This was an increase over the 46 incidents reported for 2005/06. During 2006/07, we have completely overhauled our systems and processes for reporting internal sewer flooding and validating the information about flooding incidents. Field staff have purpose-built laptop computers which provide them with information directly from the contact centre staff, identifying the properties concerned and the customers' perception of the cause of the flooding. Field staff attend the incident and, on determining the cause, enter this information into the laptop computer, specifying whether the incident did indeed cause internal flooding and whether this was due to overloading of Scottish Water's main sewers.

In 2005/06, we had very low confidence in the information about sewer flooding incidents. As our new systems and processes have become established during 2006/07, our confidence has increased. Although the new processes are now well established, there have remained residual issues of non-compliance in some areas. Some incidents were recorded with no resolution code, meaning that we cannot be sure on subsequent analysis whether the incident did cause internal flooding, whether it was caused by overloading of a main or lateral sewer, or was possibly caused by a failure of the customer's internal plumbing. For this year's results, we have taken the total of such incidents (without resolution codes) and applied them pro-rata to the categories of incident that were identified correctly with resolution codes. Of the 58 reported incidents, only 30 have complete records showing the resolution to have been internal flooding caused by overloading of a Scottish Water main

sewer. The other 28 incidents are an inferred proportion of the incidents for which we have incomplete records. Therefore, we can only identify the sites of 30 such incidents with confidence for 2006/07.

Our work in 2007/08 will improve further the compliance with our new systems and processes to reduce the proportion of incidents that are inferred to be internal flooding, rather than incidents with a full audit record of location, for which remedial work can be initiated to prevent a recurrence.

***Number of incidents of sewer flooding from other causes on main sewers***

We use the same new systems and processes to capture information about incidents of flooding from sewers for all causes, not just for hydraulic overloading. The resolution codes identified by field staff specify whether the staff consider the flood to have been caused by overloading. If so, office based staff investigate the incident, if necessary analysing the sewer network, to confirm the diagnosis.

Incidents of flooding that cannot be shown to be caused by overloading are recorded as being due to 'other causes'. These are typically blockages ('chokes') in sewers or, less commonly, collapsed sewers. Blockages occur more commonly in the smaller diameter lateral sewers than in main sewers. Scottish Water is responsible for lateral sewers, but water and sewerage companies in England and Wales are not. Therefore the information shown in the Annual Return relates only to internal flooding caused by blockages or failures of main sewers to enable a comparison to be made across all English and Welsh companies. We report the incidents caused by lateral sewers separately in the commentary to Table B.

In the same manner as we described for our analysis of internal flooding from overloading, we have applied a pro-rata increase to our records of internal flooding from other causes, to reflect the incidents for which we have incomplete information (either about whether the flood was indeed internal, or whether the cause was a main or lateral sewer, or whether it was caused by overloading). In 2006/07 we have reported 185 incidents of internal flooding from other causes on main sewers. Only 115 of these have full records of the incidents. We have included a further inferred 70 incidents to reflect our assessment of the number of incidents without full records which are likely to have been caused by failures or blockage of main sewers.

Even so, our results for 2006/07 show a dramatic reduction to 185 incidents, compared with the 617 we reported for 2005/06. We noted last year that we had low confidence in the figures because of process and system problems with data recording throughout the year. We now believe that these problems are largely overcome and we have much greater confidence in the information that is being recorded now. The aggregate information for 2006/07 necessarily includes information from the early months of the year when our confidence was lower because the new systems were not yet in place. The confidence grade for the number of incidents in 2006/07 has improved to C4 but we expect to be able to record the total for 2007/08 with greater confidence.

As with sewer overloading, our work in 2007/08 will improve further the compliance with our new systems and processes to reduce the proportion of incidents that are inferred to be internal flooding, rather than incidents with a full audit record of location, for which remedial work can be initiated to prevent a recurrence. Field staff are provided with training and support to help them achieve 100% compliance with the new reporting systems and processes.

### ***Sewer flooding (properties at risk)***

Our register of properties at risk of flooding from overloaded sewers has reduced from 1,230 in 2005/06 to 1,042 in 2006/07. This reduction has resulted from a combination of reviews of information, to remove properties where there has been no record of flooding, and investment to upgrade the sewer networks.

**Table 2.3: Properties at risk of flooding from sewers**

	<b>2005/06</b>	<b>2006/07</b>
At risk of flooding twice in ten years	577	496
At risk of flooding once (but less than twice) in ten years	653	546
<b>Total number of properties at risk of flooding at least once in ten years</b>	<b>1,230</b>	<b>1,042</b>

### ***Sewage sludge disposal***

All sewage sludge in Scotland is disposed of through approved routes in compliance with all relevant legislation.

### ***Percentage of population equivalent served by non-compliant sewerage treatment works***

The compliance of Scottish Water's waste water treatment works is unsatisfactory. In 2006/07, 20.3% of the population equivalent in Scotland was served by waste water treatment works that were non-compliant. This is significantly worse than the typical performance in England and Wales. Our performance in 2006/07 was marginally better than in 2005/06 (21.8% non-compliant) but this improvement falls far short of the targets we have set ourselves for 2010. We have a major programme of works in hand to improve performance to less than 5% non-compliance. Almost half of the waste water loads in Scotland is treated at waste water treatment works operated under PFI contracts. A number of these PFI works are non-compliant and contribute significantly to the poor performance on this measure. Our programme of works includes investment and actions at many works to improve performance.

### ***Percentage customer billing contacts responded to within 5 days***

Our response rate to customer billing contacts improved markedly during 2006/07, with 99.3% response within five days, compared with 93.3% in 2005/06. Our strategy for the 2006 – 2010 period of concentrating on customer service, together with our focus on OPA, led us to improve processes to ensure that almost every contact is answered within five days.

Since November 2006, Scottish Water Business Stream has been the sole licensed retailer for water and sewerage services in Scotland and has therefore taken over the duties of managing billing contacts with all non-household customers. The figures we have reported in the Annual Return for 2006/07 include information provided to us by Scottish Water Business Stream, to enable a report for the full year to be provided.

### ***Percentage written complaints responded to within 10 days***

Performance on this measure has shown a reduction to 98.7% in 2006/07 from 99.8% in 2005/06. This is due to a shortfall in performance by Scottish Water Business Stream from December 2006 to March 2007 as that entity set up its new systems and processes and appointed new staff. The figures reported here for the Annual Return 2006/07 are the combined results for Scottish Water and Scottish Water Business Stream.

### **Percentage telephone calls answered within 30 seconds**

We answered telephone calls more quickly in 2006/07 than in 2005/06. 97.2% of calls were answered within thirty seconds, compared with 87.0% in 2005/06. This improvement was due partly to the reduction in the total number of calls, but also due to improvements in our call handling process.

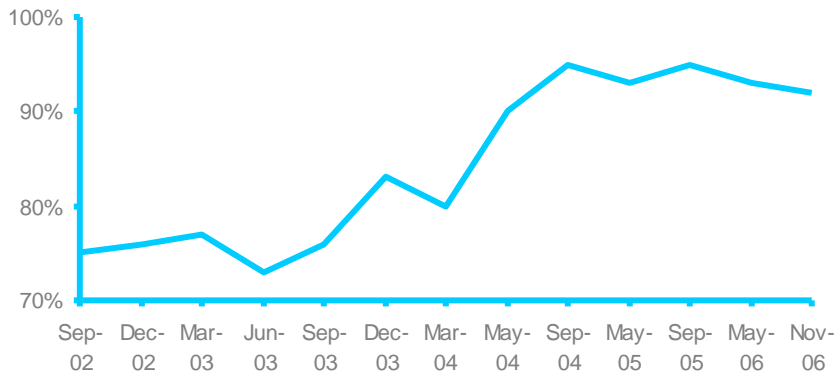
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### **Perceptions Survey**

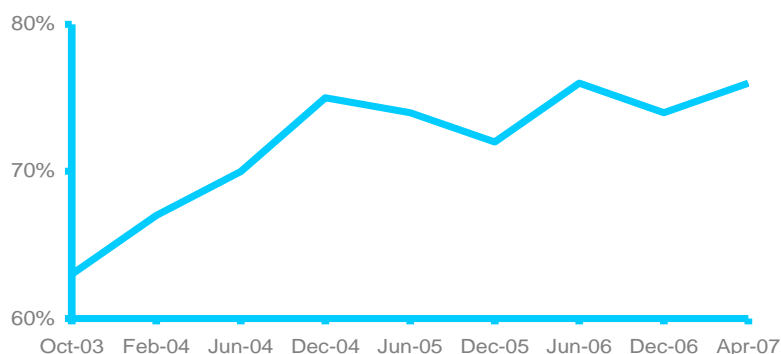
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### **Transactional Survey**

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Our performance against our published guaranteed standards of service improved from 98% in 2005/06 to 99.7% in 2006/07. This compares with 91.4% at the formation of Scottish Water.

We again maintained unconstrained supplies to all our customers during the report year and our water resources remain secure and are forecast to meet demand in 2007/08.

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

## 2.2 Drinking Water Service

### Compliance - Water quality compliance

#### Overall water quality compliance

Overall compliance with water quality standards continued to improve in 2006, with 99.76% of all water quality tests conducted in our sampling programme complying with quality standards (2005: 99.64%; 2004: 99.57%).

Compliance at customer's taps (used for calculation of OPA) improved to 99.65%, up from 99.55% in 2005.

#### 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 2006, 32,936 samples were taken for total and faecal coliform analysis. Compliance with total coliforms standards was 99.79% and with faecal coliform standards was 99.93%.

## b) water in service reservoirs

56,195 samples were taken for total and faecal coliform analysis in 2006. Compliance with total coliform standards was 99.78% and with faecal coliform standards was 99.94%.

## c) water at customers' taps

14,702 samples were taken at customers' taps for total and faecal coliform analysis in 2006 (29,404 tests in total). Compliance with the total coliform standards was 99.22% and for faecal coliform standards was 99.94%.

The following summary table highlights performance in water quality for microbiological quality from 2003 to 2006 based on regulation samples:

**Table 3.1: Microbiological quality of water**

		2003 fails	2003 compliance	2004 fails	2004 compliance	2005 fails	2005 compliance	2006 fails	2006 compliance
Treatment Works	Coliforms	108	99.69%	118	99.66%	130	99.61%	70	99.79%
	Faecal Coliforms	59	99.83%	55	99.84%	57	99.85%	24	99.93%
Service Reservoirs	Coliforms	244	99.57%	327	99.42%	224	99.60%	123	99.78%
	Faecal Coliforms	47	99.92%	73	99.87%	35	99.94%	32	99.94%
Customer Taps	Coliforms	135	99.14%	123	99.12%	138	99.03%	114	99.22%
	Faecal Coliforms	24	99.85%	18	99.87%	21	99.85%	9	99.94%

## Chemical sampling

Physical and chemical standards apply to water supplied at customers' taps. During 2006, 128,723 tests were carried out for these parameters. Of these 99.66% complied with the regulatory standards.

The following summary table highlights the performance of the key chemical parameters for 2003 to 2006.

**Table 3.2: Chemical quality of water**

	2003 fails	2003 compliance	2004 fails	2004 compliance	2005 fails	2005 compliance	2006 fails	2006 compliance
THM Total	478	85.54%	131	92.58%	101	94.20%	93	94.75%
Iron	233	94.64%	127	97.49%	79	98.52%	70	98.70%
Colour	121	96.20%	165	96.74%	81	98.49%	46	99.15%
Manganese	53	98.49%	62	98.77%	44	99.18%	43	99.20%
Aluminium	39	98.82%	27	99.46%	33	99.38%	28	99.48%

## 2.3 Wastewater Service

### Compliance - Wastewater Serviceability

#### Wastewater Treatment

The final WWTW compliance figures for 2006/07 have now been agreed with SEPA as 47 failing works against at target of no more than 44 failing works. Some of those failing works are small septic tanks which would not have numeric consents in E&W. We are currently

working with SEPA on a review of appropriate standards for small septic tanks. One of our big areas of focus for 2007/08 is improving treatment works compliance. In addition to capital investment on WWTWs, we are also planning operational interventions to improve our compliance position.

### **Bathing Waters**

Scotland had 63 bathing waters officially designated under the EU Bathing Water Directive for the 2006 Bathing Season. The bathing water results were very good for Scotland.

During the 2006 bathing season, all of the fifty eight bathing waters that can be impacted by Scottish Water's discharges complied with the coliform standards i.e. 100% compliance. 2006 was the first year that all designated bathing waters in Scotland achieved at least the minimum EU Mandatory standard, and the number of designated bathing waters achieving the more stringent EU Guideline standard has been steadily increasing over the last three years, with thirty nine (67%) achieving the guideline standard in 2006.

The Scottish Executive has de-designated 2 bathing waters, such that there are 61 bathing waters designated under the EU Bathing Water Directive for the 2007 Bathing Season.

### **Pollution Incidents**

During this report year we continued to record pollution incidents using our own definitions and procedures. The number of pollution incidents recorded in 2006/07 was 524.

In December 2006, SEPA and the Commission agreed that, in future years, SEPA would report Scottish Water's Pollution Incidents performance to the Commission on the basis of Pollution Incident 'category definitions' that are consistent with those used in England & Wales by the Environment Agency; and that we would work with SEPA to agree new and/or improved processes to aid the robust reporting of Pollution Incidents arising from our assets.

Based on the agreed category definitions we will report at March 2008 to establish our 'baseline' performance for use in future years.

### **Unsatisfactory Intermittent Discharges (UIDs)**

During 2006/07 SEPA agreed to switch the delivery of 18 UID outputs that were originally programmed for delivery in later years, replacing the 18 that were originally identified for delivery by 31 March 2007. By the end of March 2007, 3 of these had been delivered. In addition, 22 other outputs across the UID programme have also been delivered. The outputs comprise; physical improvement, operational interventions, and those where modelling has confirmed no need.

## 2.4 Progress on Q&SII Capital Investment Programme

### Q&SII OUTPUT DELIVERY

The outputs delivered to date against the WIC18 Ver 3.6 baseline targets<sup>1</sup>, are detailed in the table below which shows that overall 98% of Q&SII outputs have been delivered to the end of March 2007. 793 projects within the Quality programmes obtained sign-off from the Quality Regulators by March 2007.

Q&SII PROGRAMME			Delivered Outputs to End March 2007	% To date	WIC18 Target
DW – FT	Properties receiving FT provision of water	nr	408	100%	408
DW – P	Removal of properties from the poor pressure register	nr	1391	100%	1391
DW – WQ	Drinking Water drivers addressed	nr	556	93%	599
WM – R	Mains rehabilitated	km	3051	100%	3051
WW – C	Continuous discharges removed	nr	528	89%	589
WW – FR	Removal of properties from 'at risk' flooding register	nr	829	100%	829
WW – FT	Properties receiving FT provision of sewerage	nr	667	100%	667
WW – R	Sewers rehabilitated	km	409	100%	409
WW – UCSO	UCSO's removed	nr	413	96%	429
			Overall	98%	

A reduction on the DW-WQ and WW-C targets is being reported based on removals discussed but not yet formally agreed with the Regulators relating to wastewater assets which do not belong to Scottish Water and to duplicate outputs on the DW-WQ programme. Two flooding projects identified for future investment have been accelerated to support the Q&SII outputs in 2006-07 as the substitution project at Campbeltown has not yet obtained agreement on scope. The Campbeltown outputs will be delivered in future years as part of the Q&SIII programme. A number of outputs are forecasting to out-perform but the figures above do not include any over-delivery against target.

There remains a significant risk to delivery of a number of the outstanding quality outputs due to continuing difficulties in achieving planning approvals and obtaining agreement from Regulators on substitutions to determine scope at a number of locations.

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



## **Q&SIII Output Delivery**

Overall delivery of 10.9% was achieved against the target of 10.2%. Out-performance against a number of targets including drinking water quality, disinfection control and the number of backflow prevention devices installed will be offset by the logging down of outputs on the IPPC and Flow monitoring programmes for which formal confirmation of the changes to targets and annual profiles is awaited from the Quality Regulators.

## **Q&SIII and Q&SII Conclusion Programme Financial Profiles**

We delivered £413m of investment in line with the revised forecast profile approved by the Scottish Water Board in August 2006 and ahead of the revised target of £404m which was stated in the revised Delivery Plan (March 2007 update). The planned target for investment in 2007/08 presented in the refreshed Delivery Plan approved by the Minister is £610-650m for both Q&SII and Q&SIII.

Total forecast expenditure including the Q&SII Conclusion Programme remains within the final determination allowance for the 2006-10 period. The forecast outturn for Q&SIII Programme is £2,176m including risk reserve.

The current estimate of the Q&SII overhang investment is a net £294 million at end of March 2007 based on programme of £299 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.

### 3. Expenditure and Financial Performance

#### Consolidated financial results

The table below compares the HCA consolidated results for all Scottish Water activities, including SWBS, to March 2007. The financial results reflect Financial Reporting Standard No 17 "Retirement Benefits" (FRS 17).

£'M HCA	2006/07	2005/06	Variance
<b>Turnover</b>	<b>1,017.0</b>	<b>1,019.0</b>	<b>-2.0</b>
Operating Costs	417.6	423.7	6.1
Depreciation	225.8	251.6	25.8
Gain on Sale of Assets	-1.4	-3.9	-2.5
FRS17 Adjustment	5.6	2.8	-2.8
<b>Total costs</b>	<b>647.6</b>	<b>674.2</b>	<b>26.6</b>
<b>Operating Surplus before Exceptional Items</b>	<b>369.4</b>	<b>344.8</b>	<b>24.6</b>
Exceptional Items		4.9	4.9
<b>Operating Surplus before Interest</b>	<b>369.4</b>	<b>339.9</b>	<b>29.5</b>
FRS17 Adjustment -Finance adjustment	-2.8	1.0	3.8
Net Interest	143.3	142.8	-0.5
<b>Profit before tax</b>	<b>228.9</b>	<b>196.1</b>	<b>32.8</b>
Taxation Charge	70.6	61.3	-9.3
<b>Profit after tax</b>	<b>158.3</b>	<b>134.8</b>	<b>23.5</b>

#### Performance compared to the Delivery Plan

Scottish Water accepted the Final Determination of charges for 2006 – 2010 set by the Water Industry Commission for Scotland in November 2005. Following this Scottish Water agreed a Delivery Plan with Scottish Ministers in May 2006 that reflects the commitments required under the Final Determination.

During 2006/07, Scottish Water out-performed the income and expenditure target set out in the Delivery Plan by £23.9 million, as set out below:

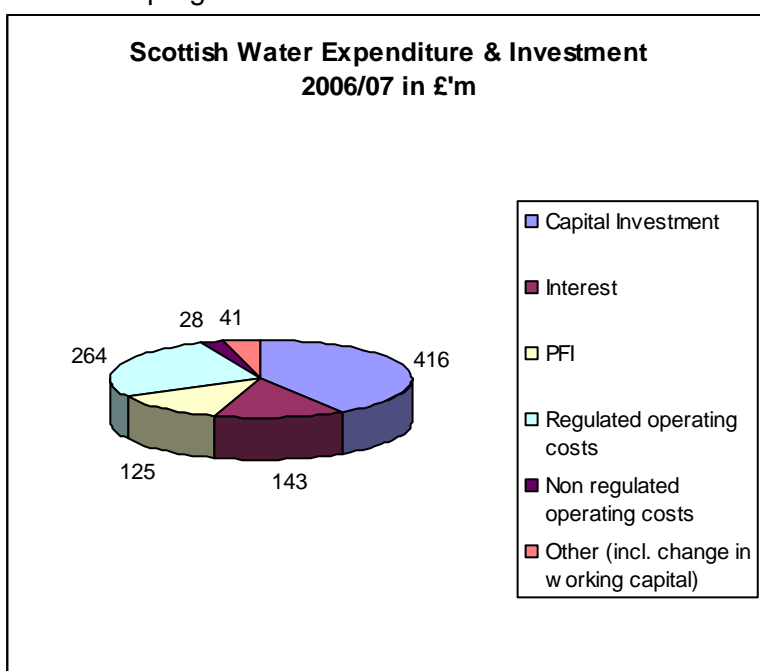
	2006/07 Performance	2006/07 Delivery Plan	Variance
	£m	£m	£m
<b>Regulatory income and expenditure out-performance</b>			
<b>Profit before tax per financial statements</b>	<b>228.9</b>		
Less non regulated profit	-1.8		
Add back regulated depreciation /amortisation	226.0		
Add back impact of FRS 17	2.8		
<b>Like-for-like profit before tax excluding depreciation and amortisation</b>	<b>455.9</b>	<b>432.0</b>	<b>23.9</b>
<b>Elements of out-performance:</b>			
Income	986.9	981.2	5.7

Operating costs	-263.5	-280.0	16.5
PFI	-125.6	-123.4	-2.2
Gain on sale	1.4	3.0	-1.6
Interest	-143.3	-148.8	5.5

<b>Profit before tax exc depreciation/amortisation</b>	<b>455.9</b>	<b>432.0</b>	<b>23.9</b>
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## HCA Financial Performance

The chart below highlights how the revenue raised during the year was used to finance Scottish Water's operational activities and capital investment programme. The surplus before tax of £228.9 million was fully reinvested in the business to enable the delivery of the capital investment programme.



## Turnover

Total turnover for the year decreased by £2.0m to £1,017.0 million. Turnover from regulated water and wastewater services supplied to household customers increased by 2.2% to £642.2 million driven mainly by the tariff increase effective from 1 April 2006. Turnover from services supplied to business customers increased by £2.5 million to £333.7 million. The underlying increase year-on-year was £3.9m or 1.2% reflecting tariff increases and the fact that trade effluent income in 2005/06 included a £1.4 million one-off payment from Scottish Courage.

The proportion of regulated turnover (£986.9 million) derived from household customers was 65% in the year ended 31 March 2007 compared to 58% in the year ended 31 March 2002, the final year of the former Water Authorities.

Turnover from the provision of non-regulated services reduced by £15.9 million or 34.5% to £30.1 million due to the reduction in the sale of contracting services to Scottish Water Solutions Ltd relating principally to mains rehabilitation work. In 2006/07 this work was undertaken internally for Scottish Water's own in-house capital delivery arm and not for Scottish Water Solutions Limited, hence the reduction in turnover.

An analysis of turnover by category is summarised below:

	2006/07	2005/06	Change
	£m	£m	£m
Household	642.2	628.3	13.9
Commercial to 30 October 2006	193.6	}	
Wholesale sales from 1 November 2006	126.8	}	2.5
Retail margin from 1 November 2006	13.3	}	
Other	11.0	13.5	-2.5
<b>Total Regulated Turnover</b>	<b>986.9</b>	<b>973.0</b>	<b>13.9</b>
Non regulated trading activities	30.1	46.0	-15.9
<b>Total Turnover</b>	<b>1,017.0</b>	<b>1,019.0</b>	<b>-2.0</b>

### Operating costs

Total reported costs of £647.6 million were £26.6 million lower than in 2005/06 (a reduction of £32.0million in cost of sales offset by a £5.4million increase in administration costs). This reduction was due mainly to lower non regulated operating costs of £16.2 million reflecting primarily the reduction in turnover highlighted above, lower bad debt costs of £9.7million due to improved cash collection performance and lower depreciation charges of £25.8million. However, these reductions were partially offset by costs associated with new activities; £5.5million for the leakage reduction programme, £1.5million for start-up costs of the Central Market Authority and £1.4million for business separation costs, reduced gains on asset sales of £2.5million and a higher FRS17 pension charge of £2.8 million.

From a Regulatory cost perspective, nominal operating costs (i.e. excluding depreciation, PFI charges, FRS 17 pension charges and costs associated with non regulated activities) increased by £4.5 million to £263.5 million compared to £259.0 million in 2005/06. However, on a like-for-like basis Group regulated operating costs reduced by £1.5m. The table below summarises this movement:

	2006/07	2005/06	Mvt fav/(adv)
	£m	£m	£m
<b>Group Regulated operating costs</b>	<b>263.5</b>	<b>259.0</b>	<b>-4.5</b>
CMA "a typical"	-1.5		1.5
Bad debt provision release "a typical"	6.0		-6.0
Separation costs	-1.4		1.4
Leakage	-5.5		5.5
Additional new opex	-3.6		3.6
<b>Like-for-like costs</b>	<b>257.5</b>	<b>259.0</b>	<b>1.5</b>

The like-for-like operating costs for 2006/07 of £257.5 million include absorption of a £5.8 million, or 27% increase in power costs to £27.3 million.

The cost of the PFI schemes in the year was £125.6 million, £5.5 million higher than in 2005/06 due primarily to the impact of additional works required at Stonehaven.

Depreciation, including infrastructure depreciation, reduced by £25.8 million to £225.8 million primarily because of a reduction in the assessed long term cost of maintaining the infrastructure assets which reduced by £22.0 million to £88.0 million.

The average number of employees during the year reduced by 106, or 2.9%, to 3,587.

**Finance costs**

During the year, net debt reduced by £12.1 million to £2,424.1 million. The reduction was driven by a £12.1 million increase in cash balances.

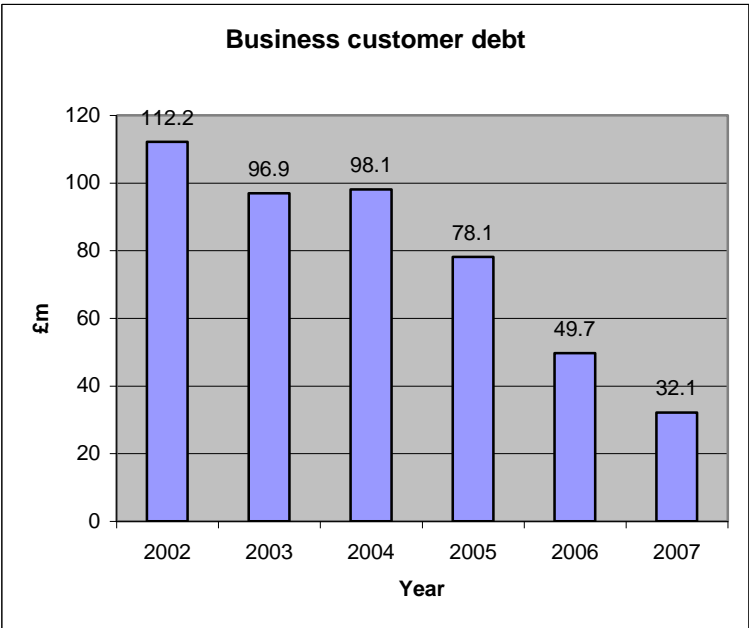
At 31 March 2007, the weighted average interest cost of the £2,436.9 million outstanding debt was 5.92% (2006 - 6.00%). Net interest payable during the year was £143.3 million, £0.5 million higher than in 2005/06. Interest cover, based on cash generated before capital expenditure, increased from 3.4 in 2005/06 to 3.7 in 2006/07.

**Taxation**

The tax charge on the income and expenditure account was £70.6 million, (2006 - £61.3 million). The effective rate was 30.8%, (2006 - 31.3%) in respect of deferred taxation. This is higher than the UK Corporation tax rate of 30% due to adjustments associated with timing differences and disallowed costs.

**Customer debt**

Amounts owed by business customers have reduced significantly over the past five years. The graph below highlights the major reductions in total debt, from an inherited position of £112.2 million to £32.1 million as at 31 March 2007, a reduction of 71.4%.



## **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 £228.9 million for the year.

### **Borrowing Limit**

Scottish Ministers set Scottish Water's maximum net new borrowing limit at £20.0 million for 2006/07. Actual net new borrowings in 2006/07 were nil.

## 4. Key Supporting Information

### Water Resources, Supply and Demand and Security of Supply Index

This year, we submitted our second Water Resource Plan (WRP) to SEPA. The aim of the water resource planning process is to enable us to move towards the optimum balance of supply and demand across Scotland and where investment is required to restore this balance, it is planned and prioritised to meet the needs of the people of Scotland and the environment. We have adopted a staged process to the delivery of the 2008 WRP which will be a robust Plan defining our water resource strategy and justifying our water resource investment programme for the SR10 planning period (2010-2014).

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

The reporting of our Security of Supply Index (SOSI) is a new requirement for Scottish Water. The SOSI is an indicator to which a company is able to guarantee provision of its planned level of service. This measure is used in England and Wales (E&W) to assess a company's security of supply to its customers but also to track changes in the service offered to customers over time.

Our SOSI is a negative number. Our analysis shows that only 37% of the population is in surplus. However, it should be noted that the standard Supply Demand Balance methodology applied results in the use of a number of uplift factors (outage, headroom & dry year demand allowance) therefore we do not consider the population in <-10% deficit ( a further 41%) to be at significant risk. Accordingly, our focus for the coming year will be 32% of the population with >-10% supply deficit.

## 5. Competition

Further to the Water Services etc (Scotland) Act 2005, Scottish Water and Scottish Water Business Stream (SWBS) have been preparing for the introduction of retail competition into the Scottish water industry.

SWBS commenced trading on 1 November 2006 and preparations are being made for the opening of the retail market in April 2008. The bulk of the staff involved in providing retail services transferred into SWBS on 31 March 2007. During 2007/08, Scottish Water and SWBS's IT systems will be separated. With the approval of the Water Industry Commission for Scotland, structures have been put in place in the interim to ensure the confidentiality of customer data, and to govern relationships between the two companies.

Scottish Water and SWBS have been working closely with the Water Industry Commission for Scotland during the report year to develop policies, procedures and licensing arrangements to progress both retail and wholesale activities, and to establish the operational arrangements between Scottish Water and retailers. A Wholesale Services Agreement has been put in place to govern the supply of water and sewerage services to retailers, and a revised wholesale charges scheme is in development which sets out charges for the new arrangements.

Scottish Water has also worked with the Commission in the development of the Market Code and participated in the Licensing Framework Implementation Group. A Central Market Authority (CMA) will be established in Autumn 2007 to manage the switching of customers between retailers, and to determine the wholesale charges to be paid by retailers. Gemserv has been appointed to provide services to the CMA, and Scottish Water and SWBS have worked with that organisation to provide data and other resources to support their activity.

## 6. Further information

### Board Changes

During the year two changes have occurred to the Board. Ronnie Mercer was appointed as Chair of Scottish Water in April 2006 and Cheryl Black, Customer Service Director resigned from the Board in November 2006. In addition, Mark Adderley (Director of Human Resources and Business Services) and Atholl Duncan (Director of Corporate Affairs) left the business during the year.

### Asset Revaluation

In our overview of the Annual Return in June 2006, we undertook to initiate a project to determine the Modern Equivalent Asset Valuation (MEAV) of our entire asset stock. To date, and including this Annual Return 2007, we have valued our assets with their Equivalent Asset Replacement Cost (EARC).

Our work on the MEAV project is progressing. We have prepared a manual setting out the method that will be used to value each class of asset (pipes, sewers, treatment works, pumping stations etc.). The MEAV will be derived using two fundamental core systems within Scottish Water:

- The asset inventory, both infrastructure and non-infrastructure, which identifies the capacity, age, condition and performance of each asset;



- The Engineering Estimating System (EES), which has been developed to enable Scottish Water to prepare cost estimates for asset components, based on historic experience in Scotland in procuring, building and commissioning water and waste water assets.

We have concluded a gap analysis which has identified the areas in which we need additional information to be able to complete the MEAV, beyond that in our asset inventory or our EES. One example is dams and impounding reservoirs. We have not built any dams in Scotland in recent years and so there is no reliable cost information on what it would cost to build them in Scotland today. We have therefore taken steps to get data from other sources (principally England and Wales) to enable all costs to be derived.

In 2006/07, we invested in a major survey of all our above ground operational assets. This has led to a significant improvement in the quality of and confidence in the non-infrastructure inventory. We visited over 5,000 sites, recording the condition and performance of every unit component. We also confirmed key information for regulatory reporting, such as the treatment type, size band or capacity. We believe that this work has built a firm foundation for the MEAV valuation later in 2007. We have also undertaken significant work to remove a backlog of information about infrastructure (below ground) assets from projects, many of which date back many years. We have updated our Geospatial Information System (GIS) accordingly.

The MEAV will be calculated for December 2007, using the inventory as at 31 March 2007. We will share the results of this analysis with the Commission early in 2008. The asset valuations in the Annual Return for 2007/08 will then be derived using the same MEAV methodology but applied to the asset inventory as at 31 March 2008.

### **Information improvements**

We have made a good start in 2006/07 in improving the completeness, availability, reliability, access to and reporting of information. This will enable us progressively to improve the confidence grades we report to the Commission and this year confidence grades have improved for the reporting of low pressure, interruptions to supply and sewer flooding.

The shortcomings we reported in 2005/06, when we were unable to report interruptions to supply in some parts of Scotland, or internal sewer flooding in any part of Scotland, have now been overcome.

We have achieved significant improvements in information in 2006/07 due to:

- improvements to our asset inventory, both non-infrastructure and infrastructure, including a major project to survey above ground sites;
- implementing new systems and processes to improve the completeness, consistency, and accuracy of field data, hence improving reliability; and
- improved reporting with all non-financial information being reported from a single department (IDR), using a single corporate data source where possible.

### **Climate Change**

We are taking climate change seriously as our customers expect nothing less.

By running our business more efficiently we have delivered benefits in terms of climate change. These include embracing new technologies such as energy efficient pumps and using renewable energy and we currently generate 5 per cent of our energy from our own renewable sources.

We are already seeing changes to rainfall patterns and we are working with SEPA and others to create 20-30 year water resource plans, to interpret this data to make better informed future investment decisions.

We know, however, that a balance is needed if we are to reduce carbon emissions while continuing to use more power to improve drinking water quality, sewage treatment and service provision across our networks. Everything we do in relation to climate change has to be centred around the need to continue to provide a quality service while protecting and improving the environment, and at a cost that our customers are willing to pay.

Scottish Water has set up a team to examine all the issues associated with climate change. Working in partnership with our regulators and the Scottish Executive, the team will focus on carbon reduction and preparing the business to adapt to climate change.

**Looking forward**

**SR10**

We have set up our team for the preparation of our regulatory business plan for 2010-14. We are progressing the development of the technical expression for Q&SIIIb such that there is more certainty around the investment requirements to inform the first draft business plan.

**Risk Based Approach to Capital Maintenance**

We are developing our capability to apply risk based capital maintenance and have recently taken Commission staff through the long term approach we will be adopting. We have established new guidelines to allow the correct allocation of capital maintenance expenditure and will be testing our historic allocations during 2007/08. We will advise the Commission if our testing highlights any significant change in previously reported expenditure.

**Governance**

The methodologies and processes used for producing the detailed information in Scottish Water’s 2006/07 Annual Return to the Water Industry Commission 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 further increases in project management and governance processes this year.

Signed..... Date...

Jon Hargreaves, Chief Executive, Scottish Water