

2007/08 Cost and Performance Report

An assessment of Northern Ireland Water's
costs and performance in 2007/08



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Foreword

The role of the Utility Regulator is to ensure that the interests of consumers are safeguarded and that customers receive greater value for money. This first Cost and Performance Report on NI Water creates transparency about progress. The report examines how NI Water performed against its promises within the Strategic Business Plan for 2007/10 and compares the company's performance to that in England, Wales and to some extent Scotland. The report examines NI Water's financial performance, efficiency, levels of service and information and data integrity. We hope that this report will help those who manage the industry in Northern Ireland to focus on achieving targets agreed in the current Strategic Business Plan and future Price Controls.

This report sets out a balanced view of NI Water. A fair assessment of the company's current status and progress must take account of its legacy: poor data, weak systems and under-performing assets. Progress is being made in all of these areas. In particular, the company is delivering a very large capital programme (£778m by March 2010), as well as transforming itself as an organisation. Comparisons with English and Welsh water and sewerage companies must be put in the context of these companies having been subject to an economic regulatory regime for almost 20 years.

It is creditable, therefore, that we can report progress by NI Water on most of its objectives. The company has outperformed its operational efficiency target for the year, exceeded its level of service targets for unplanned interruptions and leakage and met its targets for wastewater treatment. The quality of data for assessing performance against capital efficiency and outputs causes concern, as does the uncertainty over the measurement of pollution incidents; however these issues are being addressed as information systems continue to be developed. We trust that future reports will reflect an increasing confidence in the reliability of information.

While we are not fully satisfied that the information supplied by NI Water clearly demonstrates its efficiency savings, and are concerned about the increase in operating costs since 2004/05, we can confirm that it has outperformed its business plan projections, with operating costs being £3.1million less than forecast. We believe that there remains scope for significant efficiency in the future while delivering an improved level of service.

Regarding capital investment, our greatest difficulty has been linking capital projects to defined outputs. In the absence of this information, we have to monitor expenditure, which does not permit an assessment of value for money. Our focus therefore is for NI Water to improve its quarterly reporting of Capital Investment. We note the under spend of £19m in 2007/08 and that NI Water states this will result in better investment decisions through the reappraisal of its plans. We hope that NI Water will produce robust investment plans for our forthcoming price control, giving us confidence in its ability to deliver to programme.

Our work depends on accurate and reliable data and NI Water must develop its systems and improve its processes and its data quality and reliability. We have been disappointed by the lack of transparency in reporting progress against the Business Transformation Plan and expect NI Water to demonstrate that this programme is delivering results.

Looking to the future, I hope to report ongoing improvement in NI Water's costs and performance as it benefits from the delivery of its business transformation. This report shows progress in the first year of the new company and marks a starting point from which future progress can be measured.

Jo Aston
Director of Water Regulation

1 Context

The Establishment of NI Water Limited (NI Water)

NI Water Limited (NI Water) was established as a government owned company on 1st April 2007 to replace DRD Water Service as the sole water and sewerage service provider for Northern Ireland. It is governed by the Water and Sewerage Services (NI) Order 2006 (the Order) and operates under a Licence issued by the Northern Ireland Authority for Utility Regulation.

The introduction of direct charging of domestic customers was deferred in 2007/08 (and subsequently) and, as a consequence, NI Water receives a subsidy from the Department for Regional Development (DRD) in lieu of those domestic payments. The final decision on the ongoing funding arrangements for NI Water will be taken by the NI Executive after it consults on the findings of an independent review panel.

The Northern Ireland Authority for Utility Regulation (NIAUR)

The Northern Ireland Authority for Utility Regulation (NIAUR) was established as the economic regulator of the NI Water industry under the Order on 1st April 2007. Our primary duties under legislation are to:

- Protect the interests of consumers;
- Ensure that NI Water carries out its functions properly in every area of Northern Ireland;
- Ensure NI Water is able to finance its functions.

NI Water's Strategic Business Plan

The outputs to be delivered by NI Water in the period April 2007 to March 2010 and the funding required to deliver these outputs, are defined in the "NIW Strategic Business Plan 2007/2010" (SBP). Full and summary versions of this document can be found on NI Water's web site (<http://www.niwater.com/corporatereports.asp>). The business plan was negotiated and agreed between DRD and NI Water in consultation with the quality regulators (the Drinking Water Inspectorate for Northern Ireland and the Northern Ireland Environment Agency). NIAUR did not exist at that time and was therefore not involved in the process.

Annual Information Returns

In support of our objective of ensuring that customers receive value for money from NI Water, we monitor the company's performance against its business plan objectives. This is done through the review of an Annual Information Return (AIR) submission from the company. The AIR submission enables us to:

- Monitor the company's progress;
- Ensure the company's standards of service are protected;
- Compare the company's costs and performance with the rest of the UK water industry.

The results of our analysis will be published annually in our Cost & Performance Report.

The processes, consistency and quality of information collected and submitted by NI Water are scrutinised on our behalf by an independent consultant called the Reporter. The Reporter submits a comprehensive report to us which contains details of the audit findings, helping to inform our analysis.

This first annual cost and performance report provides a robust and transparent independent review of NI Water's performance in its first year.

2 Key Messages

This is the first report on NI Water's overall cost and performance. It reflects on how NI Water performed against its Strategic Business Plan targets and also benchmarks performance against the Water Companies of England & Wales and to some extent Scotland. The focus of this report is on how NI Water performed against its SBP targets. However we have also included our measurement of NI Water's levels of service using the 'overall performance assessment' (OPA). The OPA measure benchmarks NI Water to the water industry in England and Wales and shows that there is a significant gap in service levels. We will continue to use the OPA score to benchmark performance. Ministerial guidance issued for each Price Control will help inform our consideration of the importance of closing the gap in performance and of setting an OPA target.

2.1 Costs

Operating expenditure: NI Water outperformed the operating expenditure projections of its business plan by £3.1 million. However, its operating costs are high compared with those of the GB water companies.

Capital expenditure: Capital expenditure was £19m less overall than NI Water forecast in its business plan. It delayed some expenditure on wastewater treatment so that it could review its plans to check that they would be good value for money. It accelerated expenditure on water mains, where it had stronger plans, to partially compensate for the delays. NI Water will need to accelerate the delivery of SBP objectives to meet its target for the three years to 2009/10 and provide assurance of its capabilities in the planning and managing of capital programmes.

Operating efficiency: NI water met its operating efficiency targets for 2007/8, but has some way to go before it matches that of the GB water companies.

Capital efficiency: The reporting of capital expenditure will be changed in our first price control to make it clearer where outputs are being delivered efficiently. We will also review the way baseline costs are set so that the true efficiency level is clearer.

2.2 Performance

2.2.1 Water and Wastewater

Water: NI Water has begun to improve the level of service delivered to its customers and consumers, and beat its business plan target for reducing the number of unplanned interruptions to supply. However, it did not meet all its targets, particularly for mean zonal compliance, a measure of overall water quality.

Wastewater: NI Water met all its targets for compliance with wastewater treatment standards. However, it did not meet its target for controlling pollution incidents. It is not clear if this is a genuine increase, or the result of an improvement in reporting now that NI Water does not have Crown immunity.

2.2.2 Information and data integrity:

We had significant concerns about the quality and reliability of certain data submitted by NI Water. After we carried out investigations, NI Water gave us a legal undertaking that it will improve its systems of management and internal control. This is important to us because in the absence of high quality information on performance and costs, we are unable to confirm if the company is making progress in its reform programme and we will not be able to have confidence in its business plan projections. We will monitor the delivery of its undertaking and expect to see continued improvement in the quality and reliability of data submitted to us.

3 Financial Performance

NI Water submits annual regulatory accounts (in historical and current cost format) and also submits a quarterly update of progress on its capital programme and operating costs. We review the regulatory accounts together with financial tables in the AIR, and reports from the Auditor and the Reporter.

3.1 Operating expenditure

NI Water’s operating costs were £186.1million (including PPP costs of £2.87million) in 2007/08; £3.1 million less than its own SBP forecast of £189.2 million (including PPP costs of £1.91million). We term this an ‘outperformance’ of the business plan, because the company has done better than it expected to. The original SBP forecast of £192 million operating costs was revised downward by £2.8m for projected bad debt due to deferral of domestic charging.

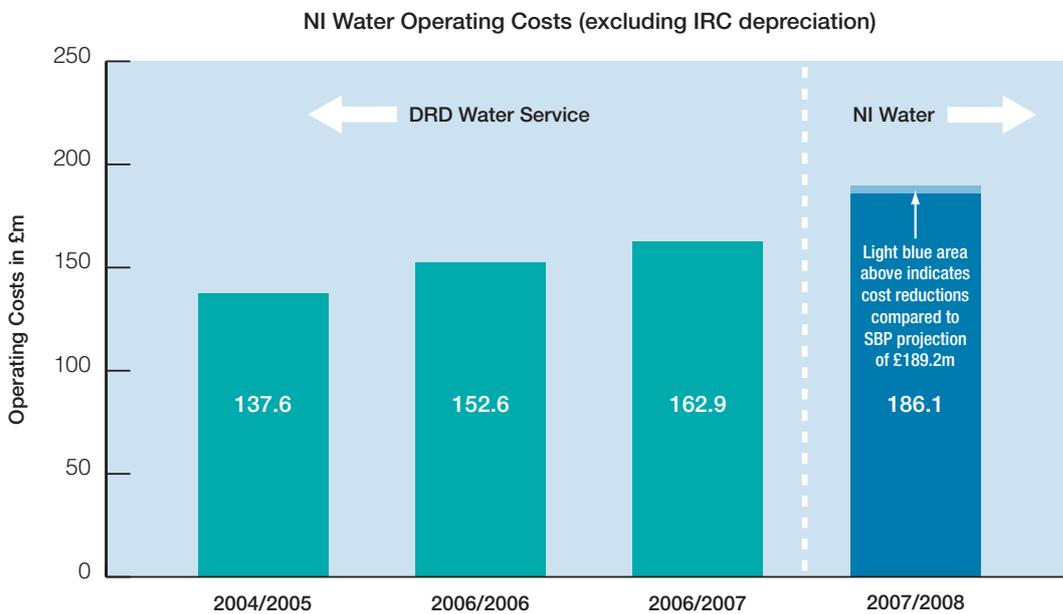


Figure 1: NI Water Operating Costs

However, operating costs have increased by £48.5million – or 35.2% – since 2004/05 while inflation has increased during the same period by 10.8%.(Figure 1). NI Water’s SBP forecasts a further increase in operating cost to £225.4m (including PPP costs) for 2009/10.

NIAUR recognises that NI Water has had to bear new operating costs associated with the move to a Government Owned Company. It is also recognised that NI Water has only recently become subject to economic regulation, while water and sewerage companies in England & Wales have benefited from almost 20 years of economic regulation, with Scottish Water subject to economic regulation for 6 years.

3.1.1. NI Water’s retained profit 2007/08

In its SBP, NI Water had forecast reserves from retained profit of £5.26 million in 2007/08, rising to £12.92 million, £21.32 million, and £34.13 million for each subsequent year to 2010/11. For 07/08 the actual level of retained profits was £7.10 million as shown in Figure 2.

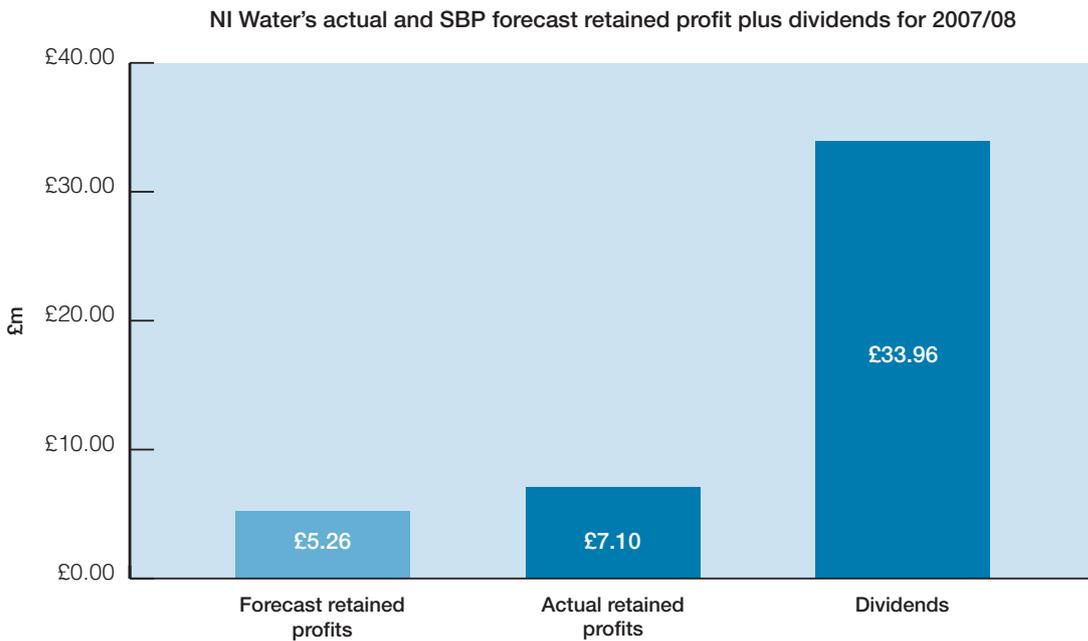


Figure 2: NI Water’s retained profit and dividends

NI Water paid a £33.96 million dividend for 2007/08 to DRD, its only shareholder, in line with the SBP projection.

NI Water’s forecast level of reserves provides limited protection against unexpected financial shocks and it may be prudent for NI Water to accumulate additional reserves.

Scottish Water, which is also a publicly owned company, does not pay dividends to the Scottish Executive. For the 2006-10 price review period the Executive and Regulator in Scotland

permitted Scottish Water to hold a £50million borrowing reserve for cost shocks. NI Water has access to revolving credit facilities of up to £55 million for additional unforeseen expenditure. To date NI Water has not utilised these credit facilities.

Scottish Water has provided for building up a ‘Gilts buffer’ arising from additional cost savings above the target set by the Regulator. We recommend NI Water should also be allowed to accumulate reserves.

3.2 Capital investment

We want to ensure that NI Water provides all customers with value for money. Within each year of the SBP (2007/8-2009/10), NI Water plans to invest around £225 million on capital works that will both maintain and improve water quality, environmental performance and customer service. This accounts for about half of NI Water’s total annual expenditure.

The scale of capital investment represents a significant challenge for NI Water. This is demonstrated in Figure 3, which compares NI Water’s capital investment per property with that in England and Wales in 2007/08.

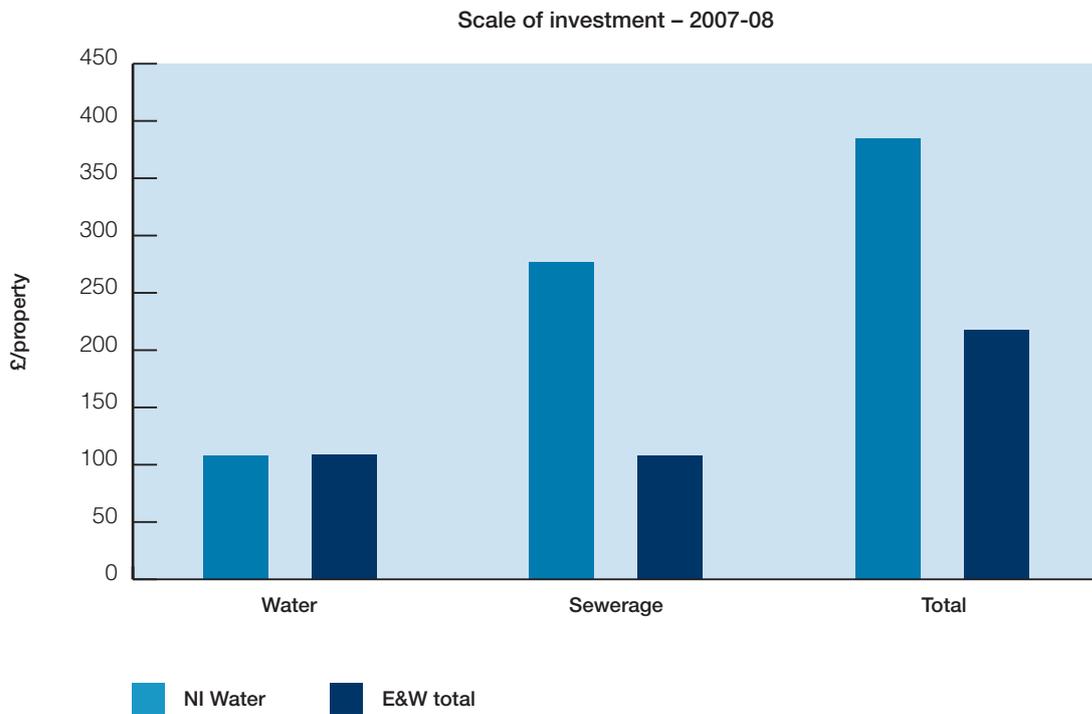


Figure 3: Scale of Investment

Our focus is on delivery of agreed outputs within the allowed expenditure, but to do this capital projects must be linked to defined outputs. Although the SBP identified the funding to deliver key objectives, it did not link individual projects to specific outputs. This makes it difficult for us to assess the delivery of the business plan objectives.

To address this shortcoming, we have required NI Water to report programme and project expenditure to us on a quarterly basis, linked to measurable outputs. Even with quarterly reporting it is difficult to relate individual projects to SBP objectives, and hence our analysis this year focuses on the overall expenditure profile. We will continue to require comprehensive output reporting for the remainder of the SBP period and will require robust output reporting during the next price control period (PC10).

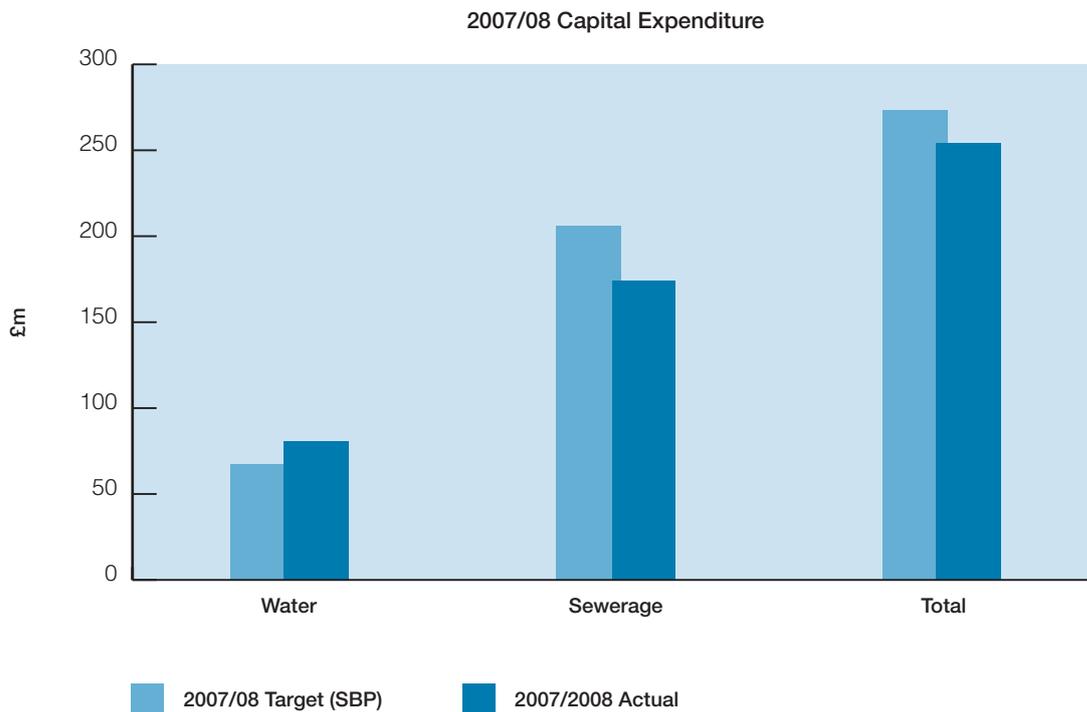


Figure 4: NI Water total capital expenditure in 2007/08

Figure 4 compares actual capital expenditure with planned expenditure in 2007/08. NI Water’s capital budget is under-spent by £19M against its planned expenditure of £273M.

The under spend on ‘sewerage’ was a consequence of delays in the wastewater treatment programme and lower expenditure than planned on the sewerage network (particularly

investment associated with Drainage Areas Plans). NI Water has stated that delays in the wastewater treatment programme resulted from the start of some projects being delayed to allow project solutions to be reviewed in order to improve value for money.

Most of the increase in expenditure for ‘water’ resulted from increased activity in water distribution mains and trunk mains. This included new development work which had not been included in the SBP and higher than planned activity in water distribution zones.

We will expect the company to accelerate the delivery of its programme, where necessary, to deliver its SBP objectives.

3.2.1 Capital works programme expenditure by asset category

Figure 5 shows capital works programme investment (excluding salaries and overheads) sub-divided by asset category – water and sewerage services split between below ground (infrastructure) and above ground (non-infrastructure) expenditure. The capital works programme represents approximately 85% of the total capital investment planned for the SBP period.

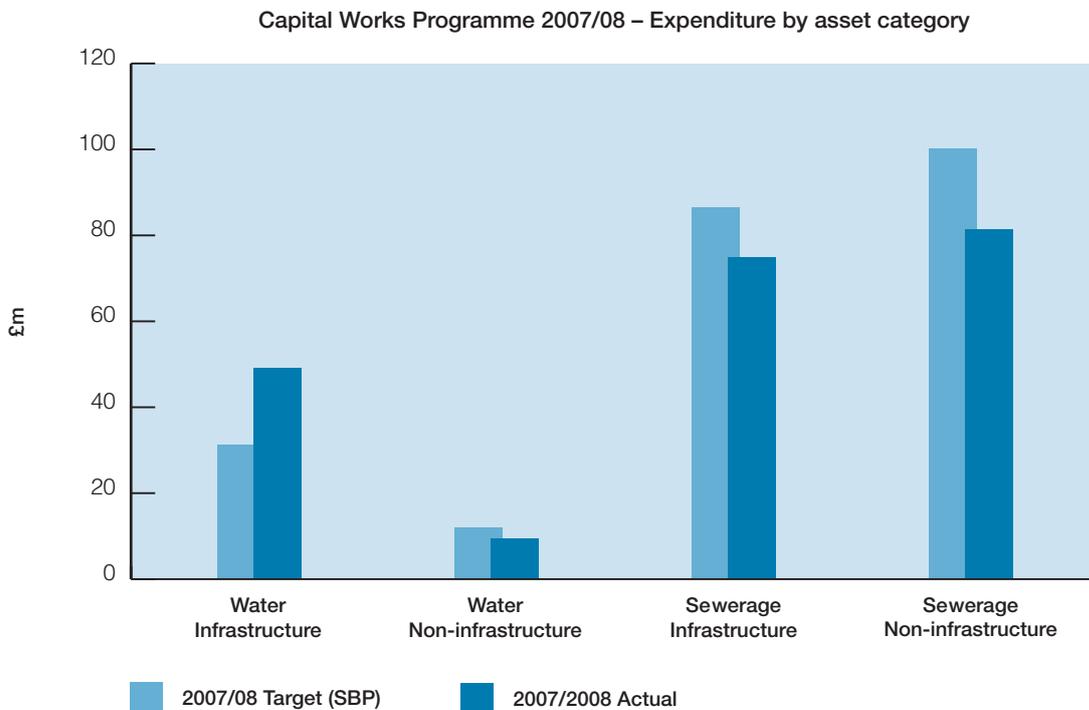


Figure 5: Capital Works Programme expenditure by asset category

Figure 5 shows clearly the emphasis on the sewage service during this SBP period, reflecting the planned improvement in environmental standards. The sewerage infrastructure category was dominated by the Belfast Sewer Project in 2007/08 (£56.3M excluding salaries and overheads). This project, involving the upgrade of Belfast's ageing sewer network, is intended to improve capacity, reduce flooding and improve environmental compliance.

3.2.2 Capital expenditure by investment driver

Investment is categorised according to its 'driver', so that it is clear why it is being undertaken. There are two main drivers for investment:

- Base service provision: Investment that is required in order to maintain the current level of service to customers.
- Enhancement: Investment that is required in order to deliver a permanent improvement to the existing level of service. Enhancement may be further sub-divided into:
 - Quality enhancement: investment required to comply with legally enforceable obligations for improving the quality of water and wastewater;
 - Enhanced Service Levels: investment providing an identifiable, measurable and permanent improvement in overall level of service to existing customers;
 - Supply/Demand Balance: investment which provides services to new customers, or accommodates increased usage by existing customers, without resulting in a deterioration of service to existing customers.

In the SBP some base service provision expenditure was allocated to enhancement. This allocation, known as 'backlog base', was intended to reflect the expenditure required to address any shortfall in maintenance investment from previous years. Total capital investment within the submission has been reported on the same basis as the SBP. This concept is generally not applied within the water industry in England, Wales and Scotland, so we have adjusted the figures provided by NIW so that 'backlog base' expenditure is included under base service provision.

Figures 6 and 7 show NI Water's water and sewerage expenditure in 2007-08, compared with planned driver allocations. It is noted that the SBP driver allocations for many projects were based on an average allocation derived from historic projects.

We acknowledge that NI Water's methodology and systems for defining and allocating investment drivers is still being developed. We therefore accept that variations in driver allocation might occur during the current SBP period. However, we do not expect this to feature in the next price control period (covering 2010-2013).

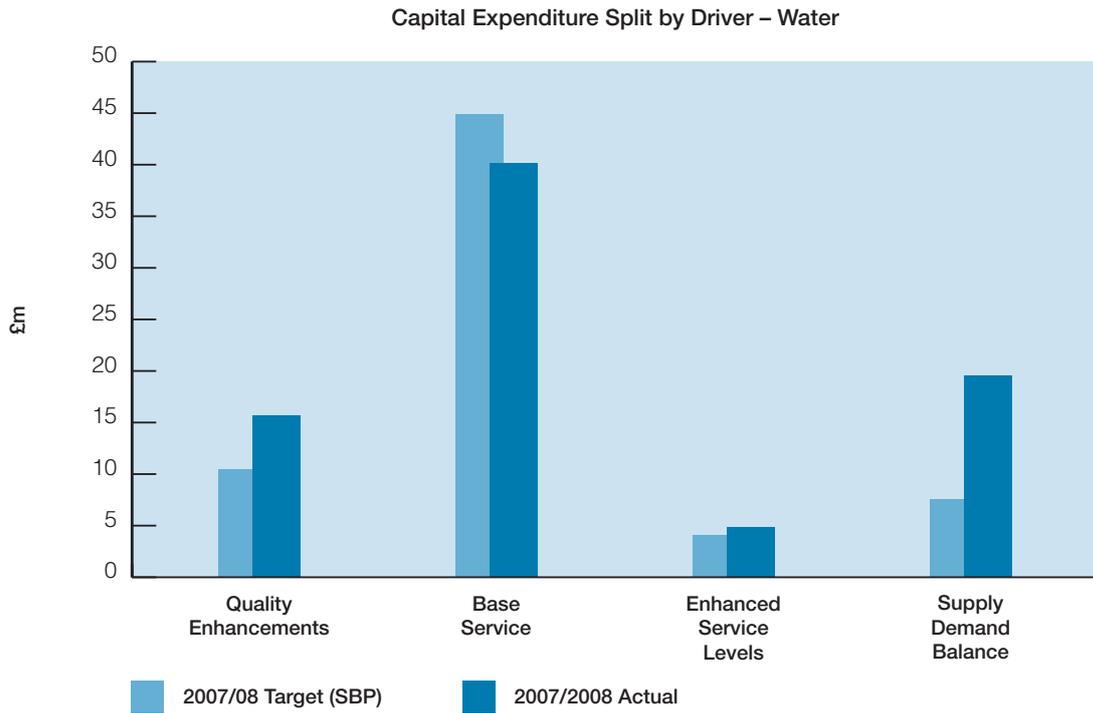


Figure 6: NI Water Capital expenditure split by investment driver - Water

Expenditure by investment driver on the ‘water’ service is broadly similar to that in England and Wales¹. ‘Base service’ expenditure represents approximately 50% of the investment programme, ‘quality enhancements’ approximately 20%, ‘enhanced service levels’ approximately 5% and ‘supply demand balance’ around 25%.

¹ Based on England & Wales total investment programme for 2006/07.

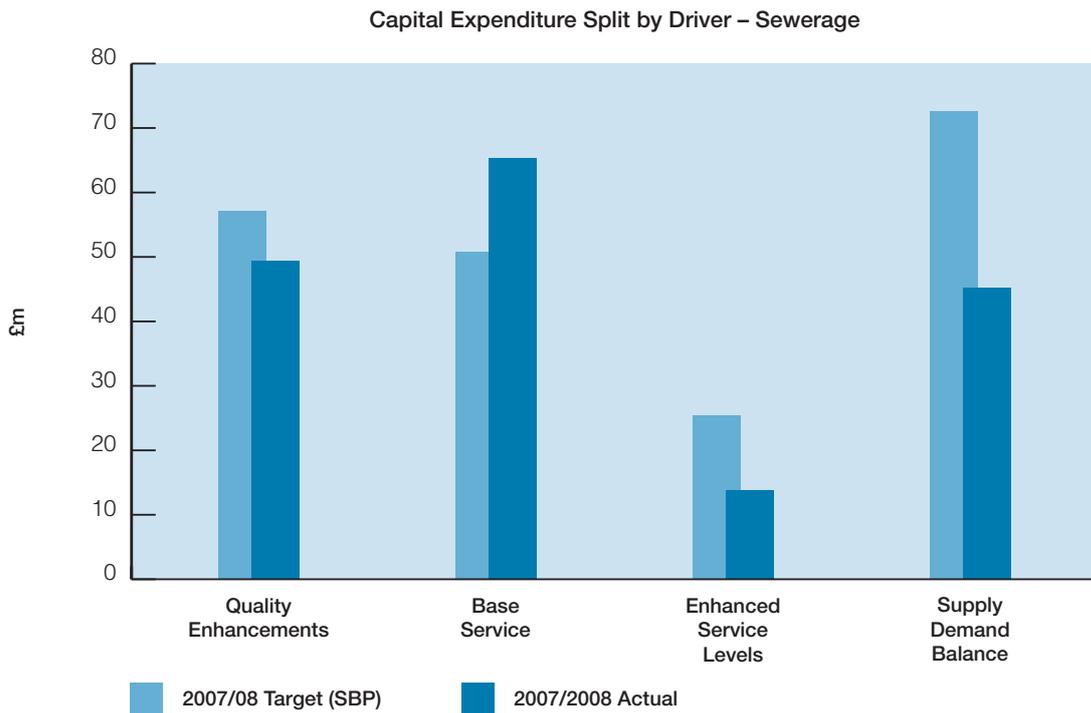


Figure 7: NI Water Capital expenditure split by investment driver – Sewerage

Expenditure by investment driver on the ‘sewerage’ service is not as closely aligned to that in England and Wales¹. The most significant variations occur in ‘base service’ provision (38% compared to 58% in England and Wales) and ‘supply demand balance’ (26% compared to 4% in England and Wales).

NI Water incorrectly allocated some ‘quality enhancements’ expenditure to ‘enhanced service levels’ and ‘supply demand balance’. This partly explains why the ‘quality enhancement’ figure appears lower than might be expected for an investment programme dominated by environmental compliance and the high ‘supply demand balance’ figure. NI Water is reviewing its allocation methodology to address this issue. We will continue to seek clarity on driver allocations so that more meaningful conclusions can be drawn from submitted data.

A lower ‘base service’ proportion would be expected for the sewerage service considering the priority placed on environmental compliance investment within the SBP. An emphasis on enhancement reflects the position in England and Wales during earlier price reviews which focused on ensuring compliance with new European Directives. Sewerage ‘quality enhancement’ investment was dominated by the Belfast Sewer Project in 2007/08 (£43M excluding salaries and overheads).

¹ Based on England & Wales total investment programme for 2006/07.

3.2.3 PPP/PFI – present and future

NI Water’s predecessor, DRD Water Service, had experienced difficulty in meeting its environmental and water quality regulatory obligations in a timely manner due to the constraints imposed by traditional public sector funding. Following a Value for Money assessment of options, the Water Service developed a Public/Private Partnership (PPP) programme to deliver 50% of NI Water’s drinking water supply (the Alpha scheme), 20% of NI Water’s wastewater treatment capacity (Omega scheme) and 100% of sludge treatment and disposal (Omega scheme). The Alpha and Omega schemes are due to be commissioned during 2008/09 and we will report in more detail on the performance of these schemes in next year’s report. The first private finance scheme undertaken by Water Service was Kinnegar Wastewater Treatment Works (commissioned in 2001). This was the only private finance scheme to operate during 2007/08.

3.3 Efficiencies

3.3.1 SBP efficiency targets

NI Water’s 2007 SBP stated that “operating efficiencies of £25.4m per annum have been achieved in the 4 years since April 2003.” The SBP did not provide a baseline cost against which this could be measured, nor evidence to back up the claim on past efficiency. Looking to the future, the SBP committed NI Water to make the following efficiencies:

Table 1: NI Water’s SBP Efficiency Targets (£m and % equivalent)

Expenditure	Monetary Target by 2009/10	Percentage equivalent by 2009/10
Operational	£44m	22%
Capital	£54.4m	17%

In reviewing NI Water’s SBP we found the anticipated efficiency savings lacked rigour and were insufficiently challenging. This point was taken up by the Independent Water Review Panel which, after seeking our advice, concluded that 40% reductions in operating expenditure were warranted. In setting water tariffs and subsidy for 2008/09 and 2009/10, we advised the DRD Minister of the scope for additional efficiency savings. Hence NI Water’s operational and capital efficiency targets for subsequent years of the SBP period were raised.

Despite additional savings, NI Water remains behind its counterparts in the industry. This is especially the case for operating expenditure with the England & Wales companies grouped around the upper right quadrant of the industry “league table” after many years of economic regulation:

Operating Efficiency Banding (Water)	A Within 5% of Benchmark					Anglian, Yorkshire, Wessex
	B Between 5% and 15% of benchmark			United Utilities	Northumbrian, Severn Trent, Southern	
	C Between 15% and 25% of benchmark				South West, Dwr Cymru	
	D Between 25% and 35% of benchmark					Thames
	E Greater than 35% of benchmark	NI Water				
	E Greater than 35% of benchmark	D Between 25% and 35% of benchmark	C Between 15% and 25% of benchmark	B Between 5% and 15% of benchmark	A Within 5% of Benchmark	
Operating Efficiency Banding (Sewerage)						

Figure 8: Efficiency Banding

The scale of challenge for NI Water to reduce its operating expenditure does not support the view that it will take longer to reduce costs. New capital investment savings can be achieved as soon as new procurement contracts are signed.

With operating expenditure, the larger the scope for efficiency, the easier it is to deliver efficiency savings sooner. Scottish Water was able to reduce operating expenditure over four years by a cumulative 30% by 2005/06, with savings front-loaded at 16%, 24% and 28% (cumulative) in the previous years.

3.3.2 Recent performance

In its 2007/08 Annual Report, NI Water states that its operating and capital efficiency targets have been recorded as “achieved” on the basis that the efficiency has been deducted from the 2007/08 budget’ i.e. it managed to remain within the budgetary constraints set by their shareholder in DRD. Without robust baselines and clear links between projects, costs and outputs, this is not a robust indicator of success.

As part of NI Water's response to our early views on enhanced efficiency targets for 2009/10, it supplied a paper entitled, "Efficiency Measurement". For operating expenditure, it attempted to compare, on a "like-for-like" basis, costs before and after becoming a government owned company (2006/07 to 2007/08) by applying accounting adjustments to each cost heading and a very favourable treatment of certain additional costs as atypical. On this basis NI Water claimed to have experienced an operational efficiency of £6.8m (4.2%²) for 2007/08 against anticipated savings from the SBP of £5.2m (3.2%) or £5.4m in 'money of the day prices'. For capital expenditure, NI Water claimed an efficiency of 4.1% or £3.8m in 2007/08 against anticipated savings of 2.1% or £1.9m.

Whilst the analysis was properly audited, the rationale and methodology for stripping certain operating expenditure out of the analysis was excluded from the scope of audit. We are not convinced that certain costs within management control, such as outsourced expenditure, should be excluded. We are also concerned about other unexplained changes to the 2006/07 baseline.

On capital efficiency, lack of robust monitoring of NI Water's delivery of outputs makes it difficult to judge whether savings are "real" or whether they are the result of delayed procurement & delivery.

3.3.3 Operating efficiency³

Our analysis compared NI Water's performance with what could be expected of a company performing at the:

- "Average" within the context of England & Wales; and
- Benchmark or "frontier"

given the state of NI Water's assets.

We have adopted a suite of models used by both Ofwat (the economic regulator of the water and sewerage companies in England and Wales) and the Water Industry Commission for Scotland (WICS) to benchmark operational and capital efficiencies across the GB water industry. The models predict expenditure based upon the characteristics of any given company. The degree of difference between NI Water's actual expenditure and predicted or "average" expenditure, and that expenditure incurred by the industry benchmark or "frontier" company, measures the amount of efficiency improvement required by NI Water.

Our analysis assesses NI Water's relative performance using 2006/07 data, the most recent year for which English and Welsh data are available.

If NI Water were to compare favourably with companies within the industry it would require reductions in water and sewerage related costs described in Table 2 and 3 respectively:

2 Opex efficiencies expressed as percentage of prior post efficiency opex.

3 For both operating and capital efficiency modelling purpose NI Water's 2006/07 information return was used. An equivalent comparison between NI Water and England & Wales companies for 2007/08 is possible pending Ofwat's release of recalibrated 2007/08 efficiency models and will be commented upon in subsequent Cost & Performance Reports.

% Reduction required:	Water Service Efficiency Improvement
NI Water to E&W “average”	48%
NI Water to Benchmark or “frontier”	54%

Table 2: Water Service Efficiency Improvements

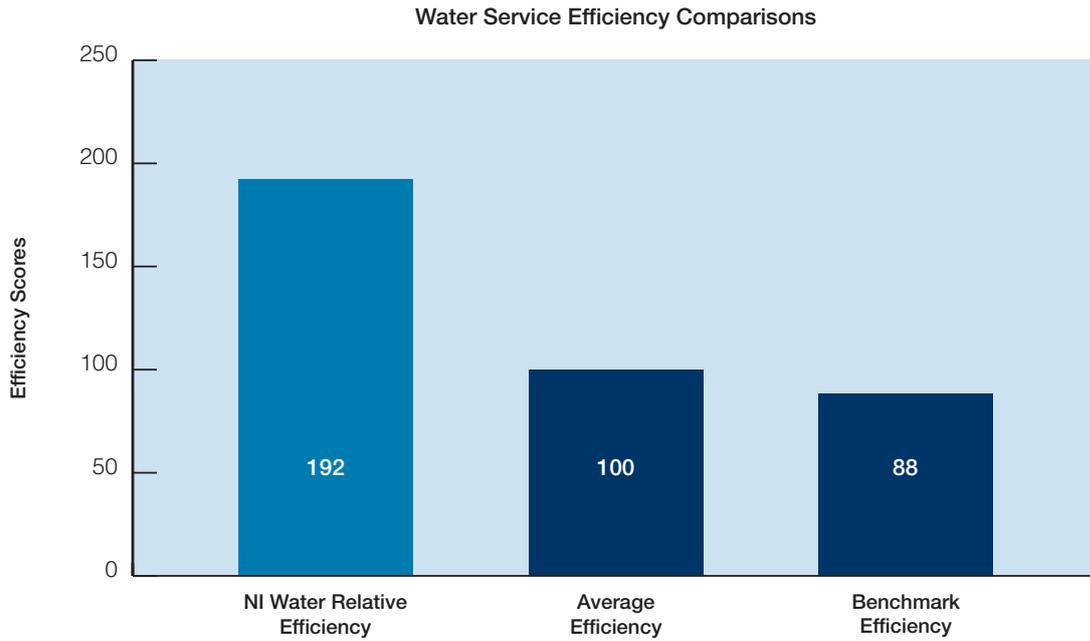


Figure 9: Water Service Efficiency Comparisons⁴

⁴ The index values are calculated from the actual monetary sum of the econometric models (excluding business activities) and rebased to the E&W average. This is demonstrated in the example below:

For the Water Resource & Treatment Econometric Model (only one part of the water service calculation):

NIW Actual Cost = £24.6m
 Predicted Cost (Based on E&W average performance) = £12.9m
 Benchmark Cost (Yorkshire Water) = £10.8m

In order to replicate these values into index scores based on the E&W average, each value is divided by £12.9m and multiplied by 100. Therefore:

For NIW = $(£24.6m / £12.9m) * 100 = 191$
 Average Company = $(£12.9m / £12.9m) * 100 = 100$
 Benchmark = $(£10.8m / £12.9m) * 100 = 84$

Required reductions can then be calculated from either the actual values or the index scores. For example in this model NIW would have to reduce its score by either 91 points or £11.7m to get to the averagely efficient company. Therefore:

- > $(91/191) * 100 = 47.6\%$ cost reduction required
- > $(11.7/24.6) * 100 = 47.6\%$ cost reduction required

% Reduction required:	Sewerage Service Efficiency Improvement
NI Water to E&W “average”	29%
NI Water to Benchmark or “frontier”	36%

Table 3: Sewerage Service Efficiency Improvements

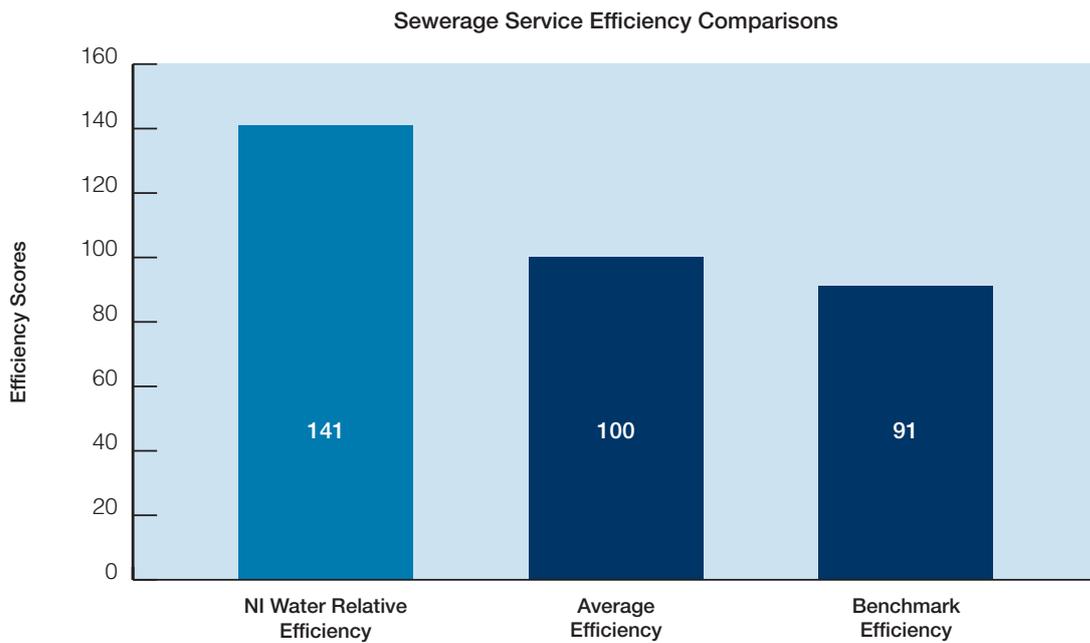


Figure 10: Sewerage Service Efficiency Comparisons

Our assessment excludes modelling of water and sewerage business activities, since NI Water does not incur comparable domestic customer related costs for billing, metering and bad debt.

Although the operating efficiency challenge facing NI Water is significant, such gaps are not unprecedented. NI Water’s situation is similar to that of Scotland at the onset of the creation of Scottish Water, also a publicly owned company, as shown in Table 4:

	Ofwat Econometric Models	WICS Alternative Model
Scottish Water	186	183
England & Wales Average	100	100
Benchmark Company	87	76

Table 4: WICS (economic regulator for Scottish Water) assessment of Scottish Water efficiency gap in 2002-03

3.3.4 Capital efficiency

Our analysis suggests that the capital efficiency targets in NI Water's SBP were reasonable, but there is some room for extension.

The cumulative efficiency target for total capital expenditure was 17% by the end of the period 2007/08 to 2009/10; an annualised target of 6%. The target was end-loaded with 9.5% anticipated in 2009/10. First year planned savings were only 2.1%, compared with the annualised target of 6% across the three years to 2009/10. NI Water's claimed capital efficiency of 4.1% (£3.8m) in 2007/08 outperforms its business plan target.

The challenge facing NI Water should not be understated and we will increase our scrutiny of capital efficiencies. Capital investment should deliver expected "outputs" in terms of its contribution to improved levels of service, so that savings are real. This is an important aspect of our duty to protect customers (and taxpayers) from paying twice for one improvement in the level of service.

Once efficiency savings are made, improvement in the level of service can occur without increasing overall operating expenditure.

4 Levels of Service

We measure the level of service delivered by NI Water using a selection of performance measures covering water, wastewater and customer service. We have used the same indicators as Ofwat uses in England and Wales and have also taken account of performance measured by the water quality regulators. We will consider and be informed by Ministerial guidance regarding the appropriateness of benchmarking all parameters in future Price Controls.

In developing its SBP, NI Water defined and set targets for a range of key performance indicators (KPIs) which set performance expectations for a range of parameters, including some of the indicators.

Our assessment of customer service covers:

- NI Water's levels of service and Overall Performance Assessment (OPA) score compared to its counterparts within the wider industry;
- A serviceability assessment based on trends in the level of service indicators and environmental performance.

4.1 NI Water's OPA

We assess the overall level of service for NI Water using our Overall Performance Assessment (OPA). This is a means of comparing performance across companies similar to that used by both Ofwat and the WICS.

NI Water's OPA score for 2007/08 shows that the scope for catch up to England and Wales companies is significant; as illustrated in table 5.

MEASURE	MAX OPA SCORE	E&W Max Collated	E&W Highest Co	E&W Average Co	E&W Lowest Co	E&W Min Collated	NI Water
DG2 Risk of low pressure	38	37	36	36	34	34	4
DG3 Unplanned Interruptions	38	37	36	31	4	4	22
DG4 Hosepipe Restrictions	13	13	13	13	13	13	13
Customer Service Combined Score	38	38	38	31	20	11	4
Drinking Water Quality	50	49	48	46	47	42	5
Sewage Sludge disposal	13	13	13	13	13	13	13
Leakage Assessment	13	13	13	13	11	11	13
Water Pollution Incidents (High & Med)	13	13	13	12	13	8	13
Sewage Pollution Incidents (High & Med)	25	25	25	23	24	19	3
Sewage Pollution Incidents (Low)	13	13	13	11	11	8	3
STW consent breaches	50	50	50	46	50	25	5
TOTAL	304	301	298	275	240	188	98

Table 5: OPA Scores

NOTES

“MAX OPA SCORE” equates to the maximum points any company might achieve
 “E&W Max Collated” represents the best scores achieved by separate companies
 “E&W Highest Co.” represents the best performing company
 “E&W Average Co.” represents the average scores achieved
 “E&W Lowest Co.” represents the worst performing company
 “E&W Min Collated” represents the worst scores achieved by separate companies

While NI Water compares poorly, neither NI Water's position nor its challenge is unprecedented. The water companies in England & Wales, and more recently Scotland have proven that once initial large efficiency gains are made, improvement in OPA is possible without increasing operating expenditure or capital investment.

The appropriateness of comparing NI Water's drinking water quality compliance to England and Wales is under review as the Value for Money of investing additional significant sums of money for small percentage improvements in drinking quality has to be assessed. Detail on the relatively small gap in percentage compliance with England and Wales water companies is provided in Section 4.5.1 of this report.

We acknowledge that NI Water's current low OPA score is partly because DRD Water Service was not historically challenged to monitor and report performance against some of the indicators in the overall performance assessment.

The challenge facing NI Water is to substantially increase levels of service for consumers, without raising the costs faced by consumers.

We expect NI Water to provide evidence of its plans to improve OPA in its Business Plan for the 2010 price control period. In line with good regulatory practice, we will challenge NI Water to provide evidence that its plan provides the best combination of service and Value for Money.

The PC10 process will create a "regulatory contract" to deliver improved levels of service for NI Water customers and consumers. The PC10 contract will set binding milestones for improvement to levels of service. We will monitor NI Water's progress towards improving its OPA score to ensure customers benefit from improved levels of service and receive best Value for Money.

4.2 Performance by individual DG indicator

Name	Description	SBP target	Performance	Comment
DG1	Not used			
DG2	Inadequate water pressure - In the UK water industry, 'sufficient pressure' is generally interpreted as ensuring a pressure of 15 metres head in the adjacent water main serving the property	Target not set	10,321 properties at risk of receiving low pressure (1.29%)	<p>Significantly worse than rest of the UK water companies.</p> <p>Although NI Water has undertaken a comprehensive analysis to assess DG2 properties, this remains an estimate with a number of issues to be resolved. It is recognised that the resolution of these issues has the potential to change the estimated figure significantly.</p> <p>We expect NI Water to improve the accuracy of its DG2 assessment prior to the next return leading to the establishment of meaningful targets and the development of plans to improve service to those customers materially affected.</p>
DG3	Unplanned supply interruptions - Unplanned interruptions are those where customers receive no warning in advance of the event.	Inferred overall performance score (OPS) = 2.31	1.43	<p>Better than target (a larger score indicates poorer performance).</p> <p>Worse than all but one company (Severn Trent) in England and Wales which had a significant incident affecting nearly 140,000 properties. We expect NI Water to continue to improve performance in this area.</p>
DG4	Restrictions on water use - this includes voluntary reductions, encouraged by a publicity campaign; hosepipe restrictions; Drought Orders restricting non-essential water use; and Drought Orders imposing standpipes or rota cuts.	Target not set	NI Water did not impose any restrictions on water use	<p>The same as all the companies in England and Wales.</p> <p>However, NI Water's security of supply index suggests that there is the potential for supply shortages in certain areas under certain conditions.</p> <p>We will review the criticality of this issue as part of the next Price Control through NI Water's Supply/Demand submission.</p>

Table 6: DG Measures

Name	Description	SBP target	Performance	Comment
DG5	Sewer flooding - Sewer flooding may occur as a result of overloaded sewers, blockages or collapses, equipment failures, or severe weather conditions. The DG5 indicator focuses on internal flooding because this causes the greatest disruption to customers and consumers	Target not set	NI Water has not recorded detailed information on the type and cause of flooding incidents. NI Water's DG5 data are of poor quality and we consider that it would not be appropriate to show a quantitative comparison of NI Water's performance with other companies.	NI Water was unable to provide robust information on sewer flooding for the report year. We expect NI Water to improve its record management and investigation systems. We expect a significant improvement in the robustness of DG5 figures for the 2009 AIR, leading to the establishment of meaningful targets and the development of plans to improve service to those customers materially affected. We recognise that the number of 'at risk' properties reported may change as further progress is made on the assessment of historic data.
DG6	Response to billing contacts - This is the percentage of total billing contacts responded to within five working days.	96%	94.97%	Worse than target - Worse than all but two companies in England and Wales. However, NI Water's performance in responding to billing contacts has improved considerably from that reported by Water Service in 06/07 (73%). We expect NI Water to continue to improve its response time in 2008/09 to enable it to meet its target.
DG7	Response to written complaints - This is the percentage of total written complaints dealt with within ten working days.	96%	90.47%	Worse than target. Worse than all but one company in England and Wales. We expect NI Water to significantly improve its response times to written complaints so that correspondents receive a substantive response within the target time.
DG8	Bills for metered customers. Percentage of metered customers who received a bill based on a reading during the year.	95%	71.8%	Worse than target, based on AIR08 data. Worse than all companies in England and Wales based on both AIR08 data and performance quoted in Annual Report & Accounts.

Table 6: DG Measures (continued)

Name	Description	SBP target	Performance	Comment
				<p>There is some uncertainty over the reported AIR08 figure as NI Water have included meters that are not supply meters or are not subject to billing for other reasons. It should be noted that NI Water reported performance of 95.14% in its Annual Report & Accounts.</p> <p>We expect NI Water to review its reporting methodology to ensure that data is reported in accordance with the specified reporting requirements and to improve data confidence.</p>
DG9	Telephone contact: Percentage of calls answered within 30 seconds	93%	94.78%	<p>SBP Target met.</p> <p>This indicator was last used in England and Wales in 2004/05. The decision to remove it reflected the difficulty in obtaining consistent data for comparative purposes from the variety of call handling systems in use. The industry average in England and Wales in 2004/05 was 95.13% (based on data supplied by companies that could measure the figure accurately).</p> <p>We note Ofwat's move to re-focus its customer service assessment on more qualitative indicators. In consultation with NI Water, CCNI and customers we will adopt a similar approach.</p>
	Telephone contact: Calls abandoned by customers	Target not set	1%	<p>Better than all but two companies in England and Wales.</p> <p>NI Water has significantly improved its performance in this area over the past two years.</p>
	Telephone contact: All company telephone lines busy	Target not set	0%	<p>Achieved the highest possible level. At no time were all lines busy, which is better than the England and Wales average.</p>
	Telephone contact: Customer call handling satisfaction – Measured as a score on a scale of 1 to 5 (5 represents very satisfied).	Target not set	4.23	<p>Worse than all companies in England and Wales.</p> <p>This was the first time this has been assessed. We expect to see an improvement in the coming years.</p>

Table 6: DG Measures (continued)

4.3 Serviceability

It is important that NI Water maintains its assets efficiently in the long term to provide the right level of service to its customers and to protect the environment. We use 'serviceability' to describe the capability of the assets to deliver a reference level of service to customers and the environment, now and in the future. Serviceability is measured using a 'basket' of indicators to represent the service experienced by customers and the capability of the company's assets to maintain service in the future.

We will begin to monitor trends in serviceability in 2009, when we will have two years of NI Water data for each indicator, but it may be several years before we can have confidence in any trends. Over time, we expect NI Water to deliver stable or improving serviceability.

4.4 Water supply/demand

NI Water has a duty to ensure that it has adequate water resources available to meet customer demand, whilst maintaining water quality standards set to ensure that water is 'wholesome and fit for purpose'. In order to comply with this duty it must assess:

- The potential growth in customer demand
- The ability of existing supply resources to cope with uncertainties in demand, for example in a dry year
- The ability to meet existing and future demand whilst accounting for required improvements in water quality standards
- The ability to maximise existing supplies through leakage reduction and the promotion of the efficient use of water by customers
- The need to develop additional resources, having considered the above

NI Water's current approach to meeting supply/demand requirements is based on a Water Resource Strategy developed in 2002 (covering 2002-2030), updated in 2007.

We assess NI Water's performance in managing the supply/demand balance by considering:

- The security of water supplies;
- Leakage;
- Promotion of the efficient use of water.

4.4.1 Security of water supplies

NIAUR have adopted an established water industry measure known as the Security of Supply Index (SoSI) to assess NI Water's ability to cope with uncertainties in demand. The index allows a company to be categorised into one of four performance bands as shown in table 7.

Band	Description	Score	No. of E&W Companies in band
A	No resource deficit against target	100	15
B	Marginal resource deficit against target	90 to 99	4
C	Significant resource deficit against target	50 to 89	3
D	Large resource deficit against target	Below	1

Table 7: Security of Supply Index

NI Water's reported SoSI for 2007/08 shows an improvement, but remains in Band 'D' and is the second worst of all water service providers in the United Kingdom. NI Water attributes the low index to fragmentation of the supply network, capacity of storage and treatment capacity rather than availability of resources. Delivery of planned investment, including PPP schemes and additional strategic pipelines, is needed and is being undertaken to increase security of supply to acceptable levels.

4.4.2 Leakage

Total leakage consists of two components:

- Distribution system losses - Losses between treatment works and the boundary of the street outside the customer's property. Responsibility for repairing these leaks usually lies with NI Water. NI Water estimates this as around 70% of total leakage;
- Underground supply pipe losses - Losses on the pipe which runs between the boundary of the street outside the customer's property and the property itself. Responsibility for repairing these leaks usually lies with the customer.

Total leakage for NI Water in 2007/08 was 25% of total distribution input.

The Economic Level of Leakage (ELL) is the level of leakage at which it would cost more to reduce leakage further than to produce water from another source. It is the optimal level of leakage in terms of direct costs to NI Water. The current ELL for NI Water is 135.5 million litres per day (MI/d), calculated in February 2007. Leakage reduction targets included in the company's Strategic Business Plan for 2007-10 are based on this figure. NI Water is due to complete its next ELL assessment in March 2009.

The graph overleaf illustrates the historical trend of leakage in Northern Ireland since 1999/00:

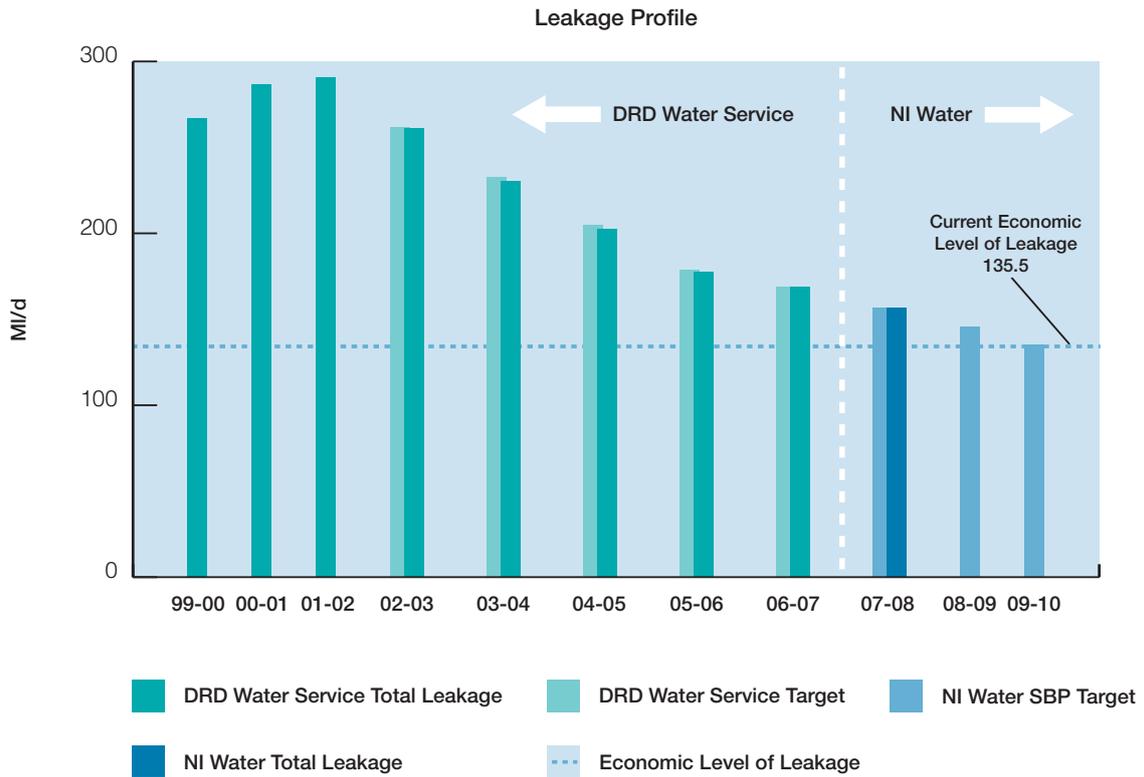


Figure 11: NI Water Leakage Profile

NI Water met its 2007/08 target of 157 MI/d, achieving a figure of 156.52MI/d. Figure 11 shows that NI Water is reporting good progress towards its leakage target. In its submission, NI Water acknowledged the need to improve the accuracy of some of the component data used to estimate leakage. It has subsequently developed an action plan to improve leakage data quality and we expect this will lead to better confidence in the leakage estimate in future submissions. It is possible that estimates of leakage levels could change as a result of this work, in which case, targets may have to be revised. We are monitoring the company’s progress on the delivery of this action plan.

Figures 12 and 13 show ‘normalised’⁵ leakage levels for Northern Ireland presented with comparable data for England and Wales:

⁵ Normalising involves dividing data by a common factor to provide more meaningful comparisons.

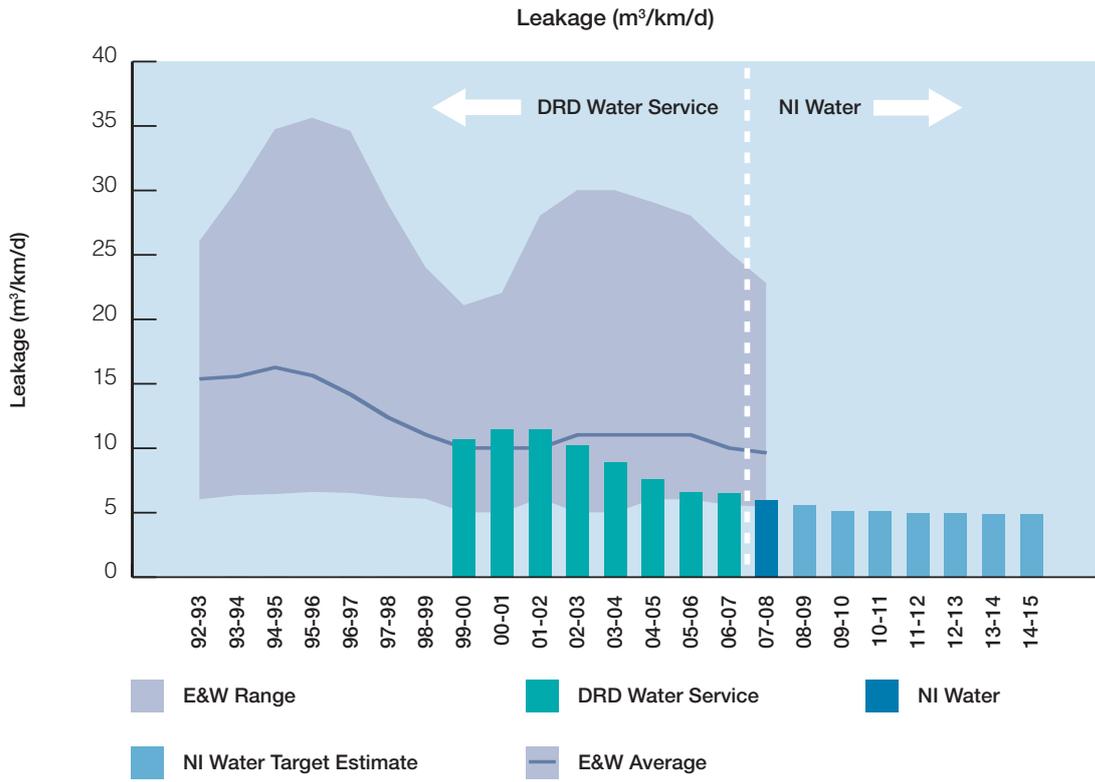


Figure 12: NI Water average daily leakage per km of water pipe

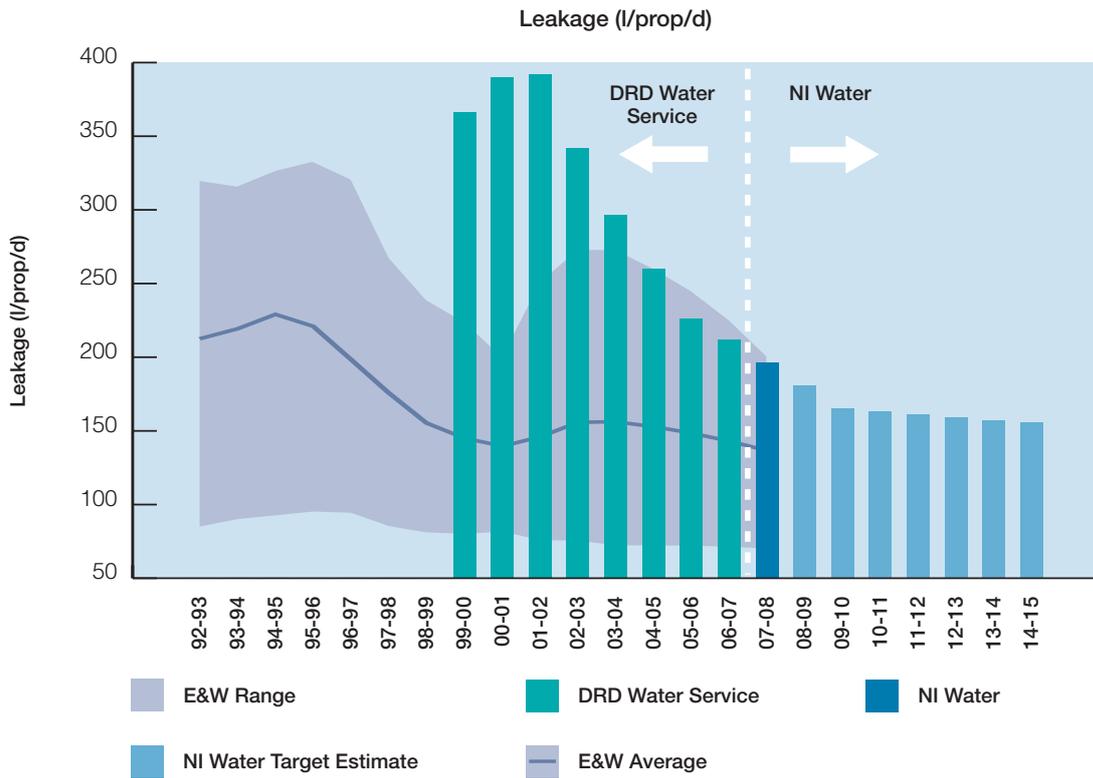


Figure 13: NI Water average daily leakage per property

NI Water’s leakage compares favourably with that of England and Wales in terms of pipe length (leakage measured in m3 per km of pipe per day). In terms of leakage per property supplied (measured as litres per property per day) it compares less favourably, being above average leakage but still within the range of the English and Welsh companies. The difference in relative performance for the two measures reflects the high length of mains per property in Northern Ireland compared to that in England and Wales.

4.4.3 Promoting the efficient use of water

NI Water has a duty to promote the efficient use of water by all its customers. We are responsible for enforcing this duty and will monitor the company's progress through the annual information return (AIR).

NI Water promotes water efficiency through an education programme and through information leaflets.

We expect NI Water to adopt an economic level of water efficiency activity within its long term plan to balance supply and demand. The DRD Water Service published a Water Efficiency Plan in 2004 (prior to the formation of NI Water) which considered the activities necessary to more effectively manage demand including promoting the efficient use of water. NI Water is currently developing a new Water Efficiency Plan which it intends to publish in 2008/09.

NI Water has indicated that it will report more fully on water efficiency measures from 2009. We welcome this commitment as better reporting will enable us to assess performance with more confidence.

4.5 Statutory obligations

4.5.1 Water quality compliance

The Drinking Water Inspectorate of Northern Ireland (DWI) is responsible for regulating drinking water quality supplies. It monitors NI Water's compliance with water quality standards and produces an annual report summarising the results (http://www.ni-environment.gov.uk/drinking_water_quality_in_northern_ireland_2007.pdf). The DWI has enforcement powers relating to water supplied by NI Water.

NIAUR monitors the company's performance against planned improvements and checks that this is achieved in an efficient and effective manner which delivers best value for money to the customer.

Figure 14 shows improvements in compliance with Drinking Water Quality standards in Northern Ireland since 1997. It demonstrates improvements in performance against increasingly stringent standards.

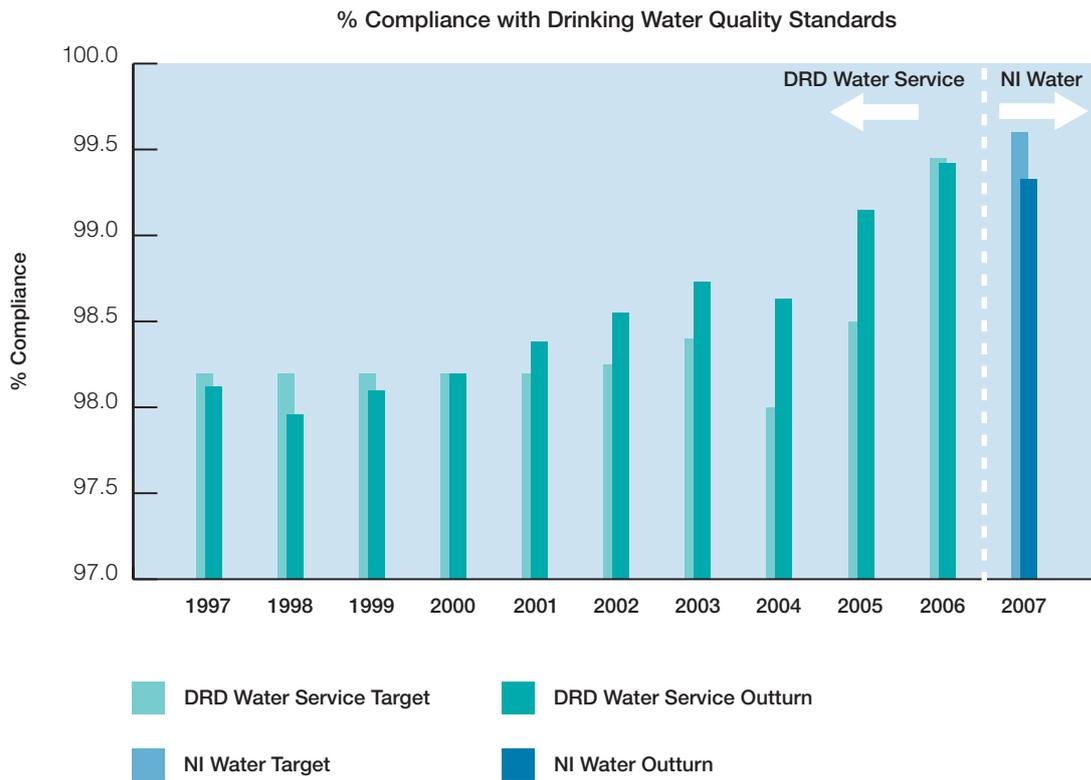


Figure 14: Compliance with Drinking Water Quality Standards

Table 8 details NI Water performance against the water quality key performance indicators (KPIs) in NI Water’s business plan.

KPI	2007 Target	2007 Actual
Compliance with Water Quality Regs – with authorised departures %	99.72	99.62
Compliance with Water Quality Regs – without authorised departures %	99.60	99.33
Mean Zonal Compliance – Water Quality at tap %	99.44	99.30
Operational Performance Indicator (Turbidity, Iron, Manganese) %	98.90	98.98

Table 8: NI Water Performance against KPI

The under-performance in 2007, evident in the table and graph above, was primarily due to poorer than expected raw water quality. This led to an increase in the number of times the standards for one of the key water quality parameters (trihalomethanes (THMs)) were exceeded. A major infrastructure project involving the treatment facilities at Dunore Point, Castor Bay, Forked Bridge, Moyola and Ballinrees is expected to deliver significant improvements in THM compliance during the incoming year.

The DWI will continue to monitor this aspect of drinking water quality, having emphasised to NI Water the need for robust water treatment processes that can cope with fluctuations in raw water quality.

DWI and NI Water have agreed that Mean Zonal Compliance (MZC) and the Operational Performance Indicator, OPI (TIM), will be the key measures used for future NI Water compliance reporting, aligning reporting with the water industry in England and Wales. MZC is used to assess overall compliance of drinking water quality at the customer’s tap. OPI (TIM), also known as the Distribution Maintenance Index, is used to assess the cleanliness and integrity of the distribution system carrying the water.

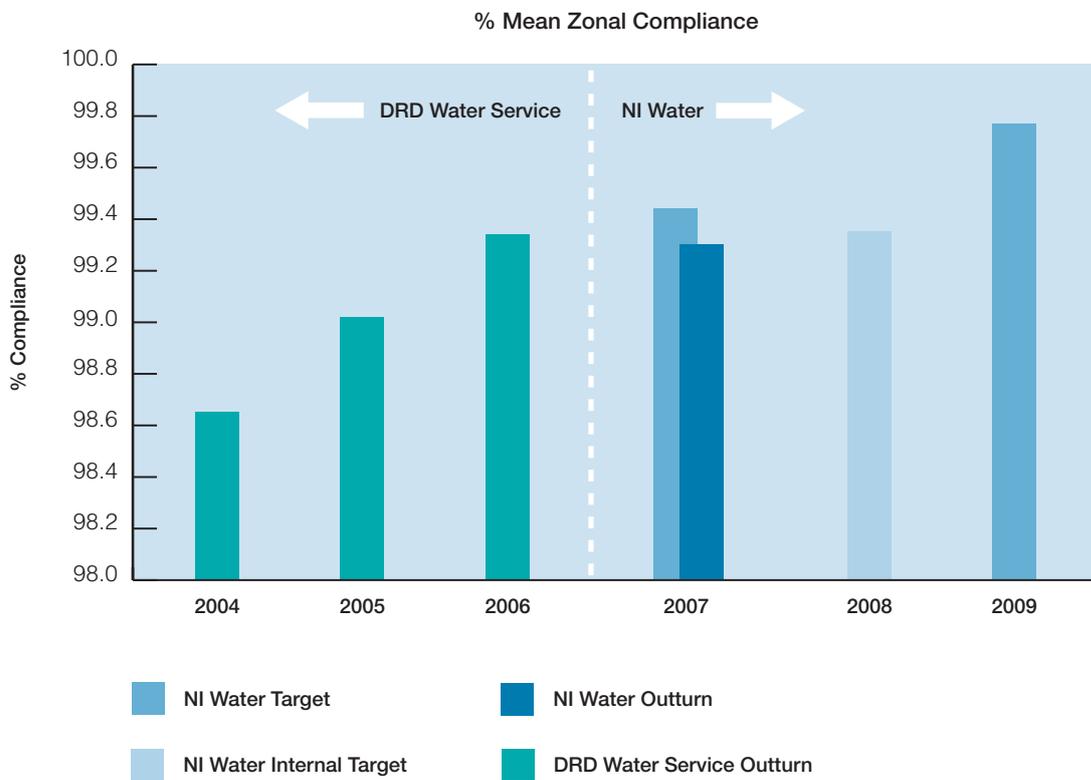


Figure 15: Mean Zonal Compliance

NI Water's performance in 2007 (99.30% for MZC) compares to an average for the companies in England and Wales of 99.96% (range: 99.92% to 100%⁶).

NI Water's performance in 2007 (98.98% for OPI (TIM)) compares to an average for the companies in England and Wales of 99.85% (range: 99.47% to 100%). The targeted improvement for NI Water included in the SBP is 99.0% by 2009.

It should be noted that NI Water customers currently enjoy a high quality of drinking water with a standard only slightly below that reported for England and Wales. We note the recommendation in the Independent Water Review Panel's (IWRP) Strand One report that consideration should be given to 'whether the increasing investment required to effect further marginal improvements in drinking water quality represents good value for money'. We support the IWRP view that clear direction on the water quality standards which NI Water is expected to deliver must be provided within Ministerial Guidance which will inform the company's business plan submission for PC10.

4.5.2 Environmental compliance

The Northern Ireland Environment Agency (NIEA) is responsible for the regulation of wastewater discharges. The NIEA monitors compliance with defined discharge consents and produces an annual report summarising the results (<http://www.ni-environment.gov.uk/waterservicesdischargereport2006.pdf>). The discharge report for 2007 will be published on the NIEA web site in February. These consents, which reflect the requirements of relevant European Directives, set conditions for the quality and quantity of effluent that may be discharged to the water environment.

The NIEA can take enforcement action against NI Water for non-compliance with consent conditions and for any pollution incidents caused by a failure to properly maintain and operate its infrastructure.

NIAUR monitors performance in delivering planned improvements and checks that this is achieved in an efficient and effective manner which delivers best value for money to the customer. Uniquely in the UK and Ireland, we also have a duty to enforce some aspects of the Urban Waste Water Treatment Regulations (Northern Ireland) 2007. To do this we monitor NI Water's compliance in the level of treatment provided and the effectiveness of the company's Trade Effluent consenting and management systems.

Figure 16 shows performance since 1997, in terms of the percentage of works complying with wastewater discharge standards in Northern Ireland. The step change in the performance and targets in 2001 results from the inclusion of additional works and the introduction of more stringent standards. This makes direct comparisons with earlier years inappropriate. Ignoring this step change it can be seen that there has been a gradual improvement in compliance levels.

⁶ Range excludes Albion Water which has only one supply zone. Albion Water MZC compliance dropped from 100% in 2006 to 99.38% in 2007.

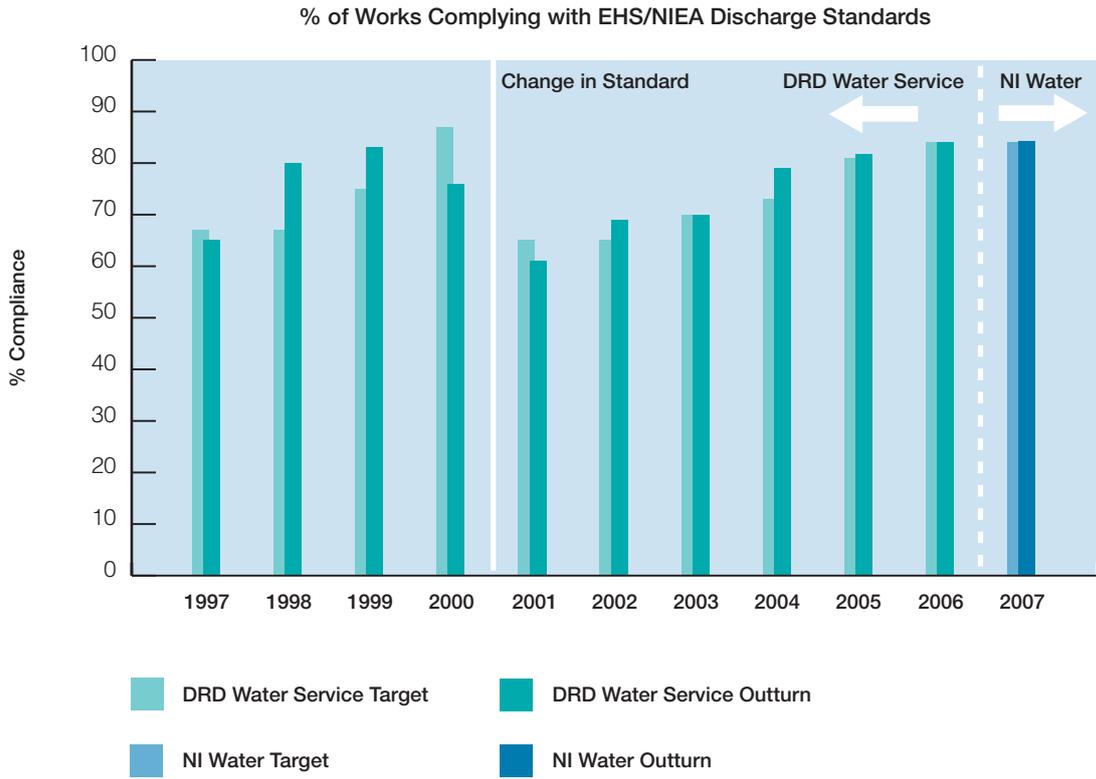


Figure 16: Compliance with EHS/NIEA Discharge Standards

Table 9 shows performance in terms of the environmental key performance indicators (KPIs) included within NI Water’s business plan.

KPI Target included in the SBP	2007 Target	2007 Actual
Compliance with Water Order consents (% of works)	84	84
Compliance with Water Order consents (% of population equivalent)	82.5	≈84
Compliance with Urban Wastewater Treatment Directive (UWWTD) Consents (% of works)	80.2	86.01
Number of High/Medium Pollution Incidents attributed to NI Water	46	60

Table 9: NI Water’s Compliance with Discharge Standards

Although the SBP targets have been met, NI Water’s compliance is less than that of other UK water and sewerage companies. Data supplied to OFWAT by the Environment Agency show that in 2007 the English and Welsh companies achieved an overall compliance with discharge consents of 97%. Many achieved 100% compliance against Urban Waste Water Treatment Consents, with an average of 99.5% for the 10 companies. When comparing environmental performance with that in England and Wales it must be recognised that a larger proportion of wastewater treatment works in Northern Ireland discharge to waterways designated as sensitive under the Urban Waste Water Directive (UWWTD) and hence are required to meet more stringent standards. If NI Water continues to meet SBP targets, 91% of works will be compliant with Water Order consents and 92.4% of works will be compliant with UWWTD consents at the end of the business plan period.

NIEA has confirmed that failure to meet the target for reducing pollution incidents may be partly explained by the increased reporting of incidents, following loss of Crown immunity, and the fact that this was not taken into account when setting SBP targets. Consequently NIEA is working with NI Water to adjust its targets for the remainder of the SBP period. We do not expect similar adjustments to be required after the end of the current SBP in 2009/10.

5 Information & Data Integrity

5.1 Data integrity

We require good quality data to enable us to carry out our regulatory duty to safeguard the interests of customers.

Prior to April 2007, DRD Water Service was not subject to the same regulatory processes as water companies in the rest of the UK. As a consequence it did not have comparable data control systems or the equivalent level of data quality. The content of some regulatory submissions submitted since 1st April 2007 has shown that deficiencies in data exist. These problems not only have the potential to impact on reported performance, but also on the ability of NI Water to accurately forecast revenue from customers.

Deficiencies in systems and the integrity of data were demonstrated when the company overestimated the number of non-domestic customers in calculating its water and sewerage charges for 2008/09 as reflected in the SBP. This resulted in a £20m shortfall in forecast revenue for the year. We investigated this and reported in July 2008 ([http://www.niaur.gov.uk/pdf%20files/Water%202008/Water%20Investigation%20Report%20220708%20\(2\).pdf](http://www.niaur.gov.uk/pdf%20files/Water%202008/Water%20Investigation%20Report%20220708%20(2).pdf)).

NI Water has recognised the issue and has identified a number of projects to rectify the problems, although some have yet to be delivered. We remain concerned that its current 'systems of planning and internal control' may be inadequate to enable the company to comply with the requirements of its operating licence. Following consultation on using our statutory enforcement powers, NI Water offered us legally binding undertakings in lieu of an enforcement order. These time-bounded undertakings have been accepted and we will monitor their delivery.

5.2 Data quality

To compare NI Water's performance with the GB water companies, we need to be confident that data submitted are accurate and reliable. The accuracy and reliability is represented by a 'confidence grade'⁷. Ofwat expects water companies in England and Wales to report data to confidence grades A2, A3, B2 or better. We have adopted the same data quality standard and where NI Water confidence grades are deficient we expect it to develop and implement action plans for improvement. Where NIW action plans are limited to the achievement of A4, B3, B4 or C2 levels, they will need to justify this and any deterioration in confidence grades from those reported in the previous annual returns will need to be explained together with the action plan for improvement.

⁷ Confidence grading is a system for assessing both the reliability and accuracy of data. Reliability relates to the source of the data; specifically looking at how the number was arrived at, and is indicated by the letters A-D with A being the best. Accuracy is measured by assigning a percentage error to the data and is measured on a scale of 1 – 6, and by the letter X. On this measure, 1 is the best. X can be used to represent the worst accuracy, small numbers or otherwise incompatible data. The best possible confidence grade that data can receive is A1.

Table 10 illustrates NI Water’s confidence grades for key indicators together with the Reporter’s independent assessment compared with the water and sewerage companies in England and Wales. It shows that data submitted by NI Water is of a lower quality than that in England and Wales, limiting the extent to which robust comparisons can be made.

Confidence grade comparison 2007/08

Water and Sewerage companies	Pressure of water DG2	Interruptions to supply DG3	Water restrictions DG4	Flooding from sewers DG5	Billing contacts DG6	Written complaints DG7	Bills for metered customers DG8	Telephone contact DG9
Anglian	B3	A1	A1	B3	A1	A1	A1	C2
Dwr Cymru Northumbrian (inc. Essex & Suffolk)	B3 B2	A2	AX A1	A2 A3	A2 A1	A2 A1	A1	C2 B2
Severn Trent	B3	B2	A1	A3	B2	B2	A1	B2
South West	A2	A2	A1	A2	B2	A1	A1	B2
Southern	A2	A2	A1	A2	B2	B2	A1	B2
Thames	A3	A3	AX	A2	B3	A3	A1	B2
United Utilities	B2	B2	A1	A3	B2	A2	A2	B2
Wessex	B3	B2	A1	A3	A2	A2	A1	B2
Yorkshire	B2	A2	A1	B4	A1	A2	A1	A2
NIW grades	B4	B3	A1	D6	B2	B2	A2	B2
Reporter grades	B4	B3	A1	D6	B2	B2	A2,C4,C5	B2

Table 10: Data confidence grades in 2007/08⁸

5.3 Response to information requests

During the 2007/08 period, we made a number of information requests to enable us to carry out our duties. On occasions, NI Water was unable to comply with our request within the specified time. We appreciate the developing nature of NI Water’s information management systems and the impact this has on its ability to respond to enquiries. However, we expect the company to improve its performance in both timeliness and quality.

⁸ The three ‘reporter’ confidence grades quoted for DG8 indicate the grades allocated to the three data entries used to calculate this performance indicator.

