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Your Ref:

Our Ref: CWIC/0910/HMT

Date: 9<sup>th</sup> October 2007

Dear Sir,

**Water Industry Commissioner for Scotland's Strategic Review of  
Charges 2010-2014: Catchment's response**

We refer to the Water Industry Commission for Scotland Strategic Review of Charges 2010-2014 Consultation Document Volume 1: Financing and governance of Scottish Water and Supporting Information note 9: Public Private Partnerships (PPPs).

Catchment companies own and operate three of Scottish Water's nine PPP wastewater schemes; the Highland, Tay and Moray schemes. Catchment has been actively delivering the Services, either in the form of construction or operation since 1997. During the period to date Catchment companies have managed a multitude of risks, for example pipeline failure, damage by third parties, premature equipment failure, odour complaints and unforeseen operating conditions. Many of these issues have involved substantial additional expenditure, for example the premature failure of dewatering equipment at over £400,000, replacement and modification of screening and pumping equipment at over £1,700,000, various odour works and investigations at over £650,000 and rising. We have also seen operational and overhead costs in many areas escalate which have resulted in, for example, a combined actual and forecast negative variance of £25m over the concession period of a single scheme. Scottish Water has remained insulated from these risks and this remains one of the core principles of the PPP contracts. In all cases, the fluctuation of revenue, particularly in dry weather, incidence of additional cost and continuation of construction related disputes marks wastewater projects as distinct from other PPP sector projects such as roads and schools, this is particularly applicable to day-to-day risks that come with the scale and nature of the services provided in major sewage treatment projects. In respect of construction related disputes, Catchment has, for example, 2 current multi-million pound disputes with construction contractors over 5 years after handover of the works and there remains the potential for further disputes up to the end of the respective latent defect periods.

The key issue is that at the point of financial close on each of these projects the Authority had formed its own view (not Catchment's) of whether each project

represented value for money on the basis of whole life cost for 25 or 30 years, as appropriate. Having satisfied itself that value for money was being achieved for the period of the Concession, the Authority signed a contract for the whole Concession Period to ensure that the value for money was locked in place. The potential for releasing more value from PPP projects does not mean that they are not already delivering value for money. Value in respect of the Catchment projects means that the works are collecting, transferring and treating wastewater and sludge to required quality standards and in return receive payment based on the units treated charged at the prescribed tariff rates. The Catchment projects all exceed the required discharge compliance targets that form the basis of our statutory consents and therefore we are delivering and exceeding the agreed value for money.

The significant scale and continuing level of risk associated with these projects appears not to feature to any extent in the proposed approach outlined in the Consultation Document. For example, the escalation of insurance costs, rates, energy, flooding, seasonal industrial problems and contractual disputes, to give only a few examples, across assets that serve many hundreds of thousands of domestic and industrial users over a wide geographical area. Rather, the Consultation Document features two headline items, the improved efficiency of Scottish Water and the reduction of interest rates. We have addressed these first two matters below and then expand briefly on the matters raised in Supporting Information note 9 thereafter.

### **Scottish Water Efficiency**

There are many publications that set out the pattern whereby efficiency is stimulated and the general consensus is that privatisation, in various forms, is a key catalyst for efficiency improvement and that this goes hand-in hand with increased investment (e.g. Note 1). The investment in PPP wastewater schemes in Scotland provided, in our opinion, a catalyst for efficiencies across Scottish Water and has allowed consolidation of network operations, staff numbers, transport fleets and sludge management together with new methods of working and innovative approaches to working. To suggest that this has happened independently of the PPP investments does not reflect the actual scale, timing and sphere of influence of the 9 PPP projects or the holistic nature of wastewater services across Scottish Water. PPP facilities and services continue to be relied upon to rationalise operational costs and the current capital investment programme, particularly in respect of sludge treatment. Catchment has first hand experience of the reliance place upon the sludge treatment facilities at major PPP centres and the use of these centres to determine the means of sludge transport, pre-treatment and treatment and disposal from new or expanding works, both for water and wastewater.

Our three concessions include the capital maintenance risk and cost for the duration of the respective contracts; there is not the same clarity associated with the medium to long term capital maintenance of Scottish Water existing and planned assets. The current perspective on efficiency and risk appear to be short term and does not appear to reflect the value delivered by PPP schemes to date, and the continuing value of risk transfer. This takes the form of, but is not limited to:-

- Continuing construction risk

- Reception, treatment and discharge responsibility for new wastewater connections and variable inputs (industrial discharges)
- Escalating customer expectations
- Increasing regulatory reporting and control
- Capital maintenance risk over 30 years
- Daily compliance assessment (in respect of payment)

Also, the standard against which the measure of efficiency has been evaluated is not clear but certainly does not use the benchmark by which Catchment concessions are judged, that being that payment is only made if the treated wastewater and sludge meet the required standards as measured on a daily basis. Scottish Water continue to be paid by customers whether the treatment and operation fails or passes, whilst Catchment is subject to a number of penalties including non-payment of revenue in the event of treatment failure; this is the sole method of determining efficiency in our projects. In our opinion the comparison drawn between Scottish Water and PPP in respect of efficiency is not valid.

### **Reduction in interest rates**

Catchment regards the performance of all three projects as being an integral part of the delivery of value for money to Scottish Water customers and has always taken, and will continue to take, a positive approach to this objective. Whilst the concise view expressed in the Consultation Document indicates an understandable desire to realise further value for Scottish Water customers it does not take account of the very real and valid obstacles to refinancing in the wastewater sector. For example, but not limited to:-

- continuing and significant disputes with contractors,
- significant variation of project revenue,
- higher operational and/or overhead costs,
- prohibitive costs associated with breaking existing funding agreements,
- low or minimal value without contract extension or residual value of assets,
- time and cost required to negotiate and implement contract changes (that may fundamentally change part way through the negotiation).
- Public and political opinion

The potential to realise value through refinancing in some concessions is very limited or nil; were it not so such activities would be well advanced by this time. Whilst there may be differing views on how to develop, deliver and present improved value for Scottish Water we would encourage the Commissioner to direct the focus of this process on clear win/win scenarios and to seek to develop the options and flexibility necessary to create additional value.

It is assumed that the focus of the consultation has been placed on profitable Concessions, and specifically those where excessive returns are alleged to be occurring, and that this will produce a form of response that best suits the purposes of the consultation process. In the interests of clarity the 3 Catchment Concessions have specific contractual provisions to ensure against super profit, and in any event it is not

clear from the Consultation Document what information has been used to calculate profitability and on what basis the status 'excessive' may have been determined.

Flexibility will be required from all contractual parties to realise an optimum value of refinancing, but in respect of zero compensation on termination and contract extension. For example, Catchment companies have little confidence that these would be forthcoming. Bond breakage costs, for example, are also too high to leave any significant value to the Concessionaire or Scottish Water and therefore the current contract limitations would have to be changed to facilitate any progress. For example, but not limited to:-

- Changes to the operation and maintenance agreements,
- Extension of the concession period
- Confirmation of compensation on termination
- Agreement on residual market value of assets at the end of the Concession
- Changes to finance agreements and warranties.

Where change is required for post contract issues, the Concessionaire and Scottish Water have generally been unable to guarantee delivery due to the restrictions of the respective contracts and agreements and this can create significant costs, for example, but not limited to:-

- Requests for Change Orders or Variations
- Completion of land documents
- Tariff adjustment events

Catchment fully supports the objective of realising value from investments: it is 'popular'. However, any increased debt risk must be underpinned by a parallel reduction in the perceived and actual risk to ensure that new financial ratios will be met; this includes a reduction in revenue and cost fluctuations (planned/unplanned), a contract period that ensures repayment of debt and interest to all parties and sufficient overall value to justify the time and cost of delivery. To give this requirement some perspective we confirm that each of the Catchment projects sought the most efficient cost of funding available to support the lowest whole life cost presented in the respective bids; an intrinsic part of this package was and continues to be a predictable debt service level achieved through fixed or protected price agreements. All Catchment projects will have to address these issues before refinancing can be considered and none has reached a point where there is adequate certainty of either the outcome or value to justify significant resource application.

### **Supporting Information note 9: Public Private Partnerships (PPPs)**

In the Section headed Our Approach in the Strategic Review of Charges 2006-10 it is stated that customers bills may be funding substantial and possibly excessive returns by equity holders in the PPP schemes. It is assumed that the repayment of equity principal and interest is not included in any assessment of 'excess' as this is a fundamental part of the project funding and it ignores the possibility of there being no equity return and also that each of the Catchment concessions includes mechanisms to limit such returns.

The legal and contractual entitlement of each concessionaire is set out in the relevant Concession Agreement. In addition, where there is a need for a Change or Variation, necessary consent/permissions and payment mechanisms are prescribed and, whilst not perfect, are the exclusive remedies afforded by the contracts for such changes. None of the mechanisms compensates Catchment for additional costs or reduced or lower revenue. The Catchment projects' performance, and our relationship with Scottish Water, has been and remains excellent and we can see no basis for us to act out-with the provision of the contracts. PPP contracts are unique and bespoke and we do not regard the one size fits all approach, as indicated in the Consultation Document, as being appropriate.


In the interests of clarity, Catchment has not been part of any shortfall in performance, indeed performance has exceeded the contract requirements in all cases, and Catchment has not requested or expressed any entitlement to receive additional funds from the Scottish Water capital programme.

#### **Our Proposed Approach for 2010-2014**

It is indicated in the bullet points that renegotiation [is] to reflect reduced levels of costs being borne by the contractors. Catchment has generally experienced increases in costs in almost all areas of operation. Using a single project example, we have an actual and forecast increase in operational costs which is countered by overhead cost reductions giving a net positive variance of c. £4m over the concession. However, the revenue variance over the same period is negative and in excess of £45m so it is not realistic to be selective. In addition, changes in debt and interest costs, where such rates can vary (excludes bonds) result in minimal value variances as rates have generally been sought from lenders specifically to protect against rate variation, up or down.

We suggest that one recommendation that is necessary following this consultation process is that the Water Industry Commissioner establishes a liaison link with each concessionaire, coordinated through Scottish Water. This approach would ensure that the specific needs of each project can be determined, without generality or presentational influences, and that this includes the balance of risk and return that is absent from Scottish Water investments and operations. We regard this as the only practicable route to ensure that all parties are sufficiently confident in the cooperation and understanding of the other parties, and their rights, to allow any additional risk and value arising from refinancing to be equitably allocated and that value can be seen to have been added.

Yours faithfully,



David Wishart  
Asset Manager

For and on behalf of Catchment Companies (Catchment Tay Limited – SC186492,  
Catchment Moray Limited – SC206595 & Catchment Limited – SC163035)

cc. John Telfer – Scottish Water

Note 1:- Water and Environment Journal, Volume 21, September 2007. Number 3 – Perspectives of different parties involved in the selection of capital equipment for sewerage and wastewater-associated infrastructure investment projects. M.G.Faram, J.M.Saker & V.M Story (and associated references).