

Methodology information paper 9: Our Proposed Approach to Public Private Partnerships (PPPs)

Introduction

This information paper discusses the nine PPP wastewater treatment contracts inherited by Scottish Water from the three former water authorities. These contracts account for more than 10% of Scottish Water's current annual spending. It will therefore be important to examine the experience of using PPP in the Scottish water industry and ensure these contracts continue to deliver value for money to customers. Scottish Water should be alert to opportunities to reduce the costs associated with PPP contracts.

In the last Strategic Review of Charges we, in the Commission, analysed these PPP contracts in some detail¹. We decided not to apply an efficiency target for this element of Scottish Water's costs at that time. However, we did confirm that we would return to this issue in the 2010-14 review. We noted the potential opportunities for Scottish Water to seek better value for customers from these contracts and said we would seek evidence as to whether these opportunities had been realised. This information paper sets out our findings from the last review and discusses how we propose to take this work forward.

Our Approach in the Strategic Review of Charges 2006-10

Our examination in 2005 of the operation of the PPP contracts concluded that, while the contracts for the nine projects represented good value for money at inception, it was less certain that this remained the case. We presented analysis that suggested that customer's bills were financing substantial and possibly excessive returns by equity holders in the PPP schemes.

We therefore considered setting an efficiency target for the payments to PPP contractors. We considered that this would provide an incentive for Scottish Water to pursue opportunities with the PPP contractors to share the benefits of refinancing.

A number of respondents to our methodology consultation in October 2004, including Scottish Water and Water UK along with the PPP contractors, did not consider that this was appropriate. Their arguments

¹ The Strategic Review of Charges 2006-10 : The draft determination, Volume 5, Section 3, Chapters 8 to 11 and The Strategic Review of Charges 2006-10 : The final determination, Section 3, Chapter 14, Page 153

included concerns that this proposal had not been properly signaled and breached the regulatory principles of consistency and predictability set out by the Better Regulation Task Force. They also questioned whether it was fair to ask Scottish Water to renegotiate the contracts, given that they were always intended to be long-term arrangements. They argued that the risks of the projects would have been averaged over the life of the projects.

We considered that these arguments had only limited merit. We did, however, consider that it would be possible to argue that we had not given sufficient notice of our intention to challenge the PPP contractors to provide better value for money for customers. We therefore decided to delay the decision about setting an efficiency target for PPP to the next regulatory control period.

In our draft determination we made it clear that our scrutiny and monitoring of the PPP projects would increase for the next regulatory control period. We stated that, if we did not see an improvement in the value for money of these contracts, we may seek to establish an efficiency target for the 2010-14 Strategic Review of Charges.

In the final determination we allowed for Scottish Water's estimated PPP costs without applying an efficiency target. In establishing the allowed for level of PPP costs we included an additional allowance to address the shortfalls in performance of these contracts relative to the level of service required by the ministerial objectives. This amounted to around an extra £5 million a year by 2009-10, sufficient to finance at least £30 million of capital expenditure by the PPP contractors.

Our Proposed Approach for 2010-14

In the Strategic Review of Charges 2010-14 we propose to establish whether Scottish Water have sought to improve value for money for customers either through:

- refinancing the contracts; and/or
- renegotiation to reflect reduced levels of revenue costs being borne by the contractors.

The financing costs included in the annual PPP charges cover the interest charges on loans taken out by the consortia and the equity return required by the consortia partners on their initial investment. Typically, the equity funding of a PPP contract is relatively small.

We have previously identified two principal reasons why we believe that it may be possible to reduce the cost of capital included in the annual charge to Scottish Water:

- over the period since the contracts were established, the real cost of long-term borrowing has declined quite significantly; and
- some of the earlier contracts may have included an additional risk premium in the cost of capital to reflect the novelty of delivering waste water projects through PPP.

There is likely to be an opportunity to refinance loans that were taken out at the start of the construction of the waste water treatment works. If borrowing costs were reduced by the consortia and the benefit was not shared with customers, then the entire benefit of the reduced cost and resulting higher profit earned would accrue to the equity partners in the consortia.

We understand that most of Scottish Water's PPP contracts contain no mechanism to ensure that customers can share in any gains from the refinancing of debt. However, this should not preclude Scottish Water from proactively discussing refinancing opportunities with its PPP contractors. HM Treasury guidance is that the public sector partner should receive 30% of the benefit of any refinancing, in such cases, of legacy PPP contracts.

In the absence of evidence that Scottish Water have sought to refinance the PPP contracts, we will consider what incentives are required to ensure the potential benefits to customers are realised. In particular, we will consider whether it will be appropriate to impose efficiency targets on PPP expenditure in the 2010-14 period.

We recognise that our proposed approach in seeking to maximise the benefits for customers of these contracts will be unpopular with the PPP consortia. However, our proposed analysis will indicate the extent to which these contracts are still providing value for money for customers. This is consistent with our duty to establish the lowest reasonable overall cost of providing these wastewater services.

Related documents

'Our work in regulating the Scottish water industry : The scope for operating cost efficiency : Water Industry Commissioner for Scotland, October 2004.

'The Strategic Review of Charges 2006-10: The draft determination',
Volume 5, Water Industry Commissioner for Scotland, June 2005.

'The Strategic Review of Charges 2006-10: The final determination', Water
Industry Commission for Scotland, November 2005.