



How charge caps could change between Strategic Reviews: interim determinations

This information note explains the circumstances in which it may be necessary to set charge caps that are different to levels determined at a Strategic Review.



Introduction

We have a statutory duty to promote the interests of customers. We principally do this by setting prices for water and sewerage services that deliver Scottish Ministers' objectives for the water industry at the lowest reasonable overall cost. We determine charge caps for four years, during which time Scottish Water must deliver all of the environmental, water quality and customer service outputs so financed. This is the regulatory contract. This process provides stability to customers and incentives to Scottish Water.

At our last Strategic Review of Charges in 2005 we set charge caps for the 2006-10 regulatory control period. We made assumptions at that time about Scottish Water's future costs and revenues, making allowances for any costs that we expected to change over the four-year period. In addition, charge caps are adjusted annually to allow for general inflation. Scottish Water's management must control and influence costs in order to deliver the regulatory contract. It can do this, for example, by changing processes if a particular input becomes more expensive.

For Scottish Water – a regulated business with an obligation to supply – it could be necessary to amend charge caps to take account of changes in legal obligations, such as new water and environmental quality obligations. There may also be substantial and unexpected changes in costs and revenues that are outside the control and influence of management. This could make it necessary to adjust the charge caps before the end of the regulatory control period to ensure Scottish Water's continued financial viability. Such changes would be exceptional and we would need to be satisfied that they were also beyond the influence of a determined management.

The process of adjusting charge caps between Strategic Reviews is known as an 'interim determination' (or IDoK)¹.

How we determine whether unexpected costs are outside the control and influence of management

First we identify events that managers can influence. We then assess the reasonableness of any claim against these principles:

- Is the event already included in charge caps, either through our benchmarking or through other allowances?

¹ Interim determination of K: K is the letter used to denote the percentage that Scottish Water is allowed to increase or decrease prices each year, relative to inflation.



- Is the event a result of prior management action?
- Can management change policies and procedures so that the event does not affect charge caps?
- Have managers sought to mitigate the effects of an event to the maximum extent possible?

We then determine whether this is a 'change item'.

Triggering an interim determination

Not all change items will trigger an interim determination. A change item may not trigger an interim determination in the following cases:

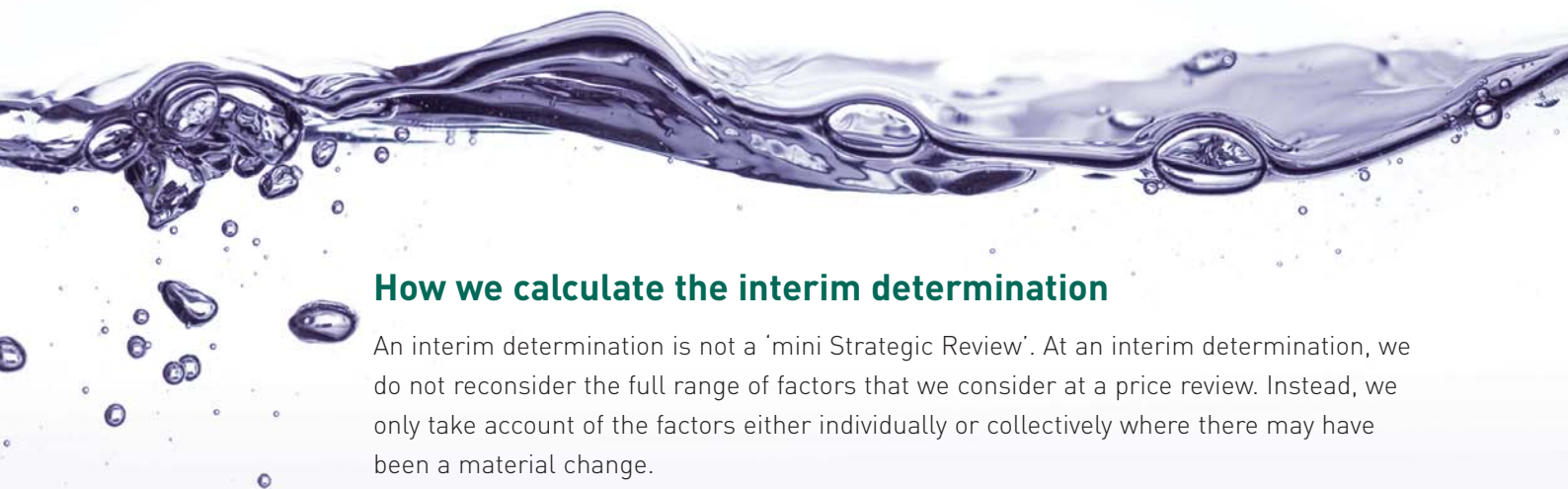
- If Scottish Water's management considers that it does not need to seek an interim determination to deliver the regulatory contract.
- If the effect is already captured in the Retail Price Index (RPI).
- If the effect is not large enough.

Scottish Water's management may choose not to seek an interim determination if it feels that it can deliver all of the outputs without raising charges to customers. This may be the case if it has outperformed other assumptions that we made when setting prices.

We set charge caps with reference to the annual change in the RPI. Since Scottish Water's charges are linked to inflation, it is fully protected from changes that affect the economy in general. We would not, therefore, consider an interim determination for an effect that is economy-wide, as this would double-count the impact of any such change and unnecessarily increase customers' bills. The effect of a change item is reduced if the change in RPI partially takes account of it.

In order to assess whether a change item is substantial, we apply a 'materiality test'. A change item will be considered large enough to trigger an interim determination if it is greater than a threshold. The threshold is that the net present value of the change item is at least 10% of Scottish Water's turnover in the year of the request for a reconsideration of charge caps. If the change item passes the materiality test, it is known as a 'material change item'.

We will also consider an interim determination where the combined value of two or more change items passes the materiality threshold.



How we calculate the interim determination

An interim determination is not a 'mini Strategic Review'. At an interim determination, we do not reconsider the full range of factors that we consider at a price review. Instead, we only take account of the factors either individually or collectively where there may have been a material change.

Where a material change item is revenue, operating expenditure or maintenance, customers pay for the expenditure in the year in which it is incurred. This means that at an interim determination we recalculate charge caps that allow Scottish Water sufficient funds for the full change in each year.

Where a material change item relates to enhancement capital expenditure, it may be prudent for this to be funded over a number of years. If an interim determination finds that an increase in enhancement investment is required (and, consequently, a need for further borrowing from the Scottish Government beyond levels currently agreed), we would need to discuss with the Scottish Government whether it wished to redeploy resources within the programme or to make further lending available.

Timeline

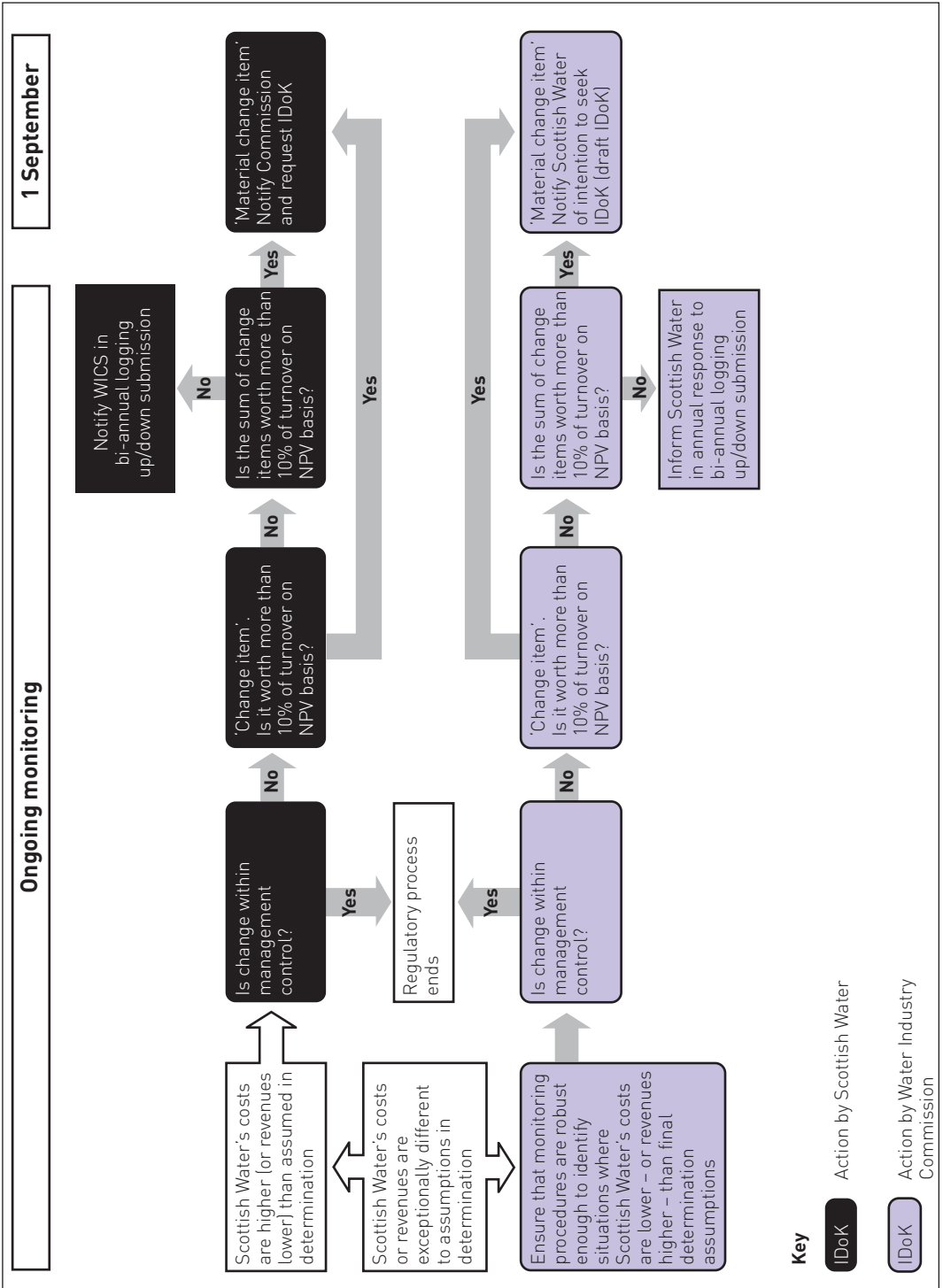
An important feature of interim determinations is that they must be triggered by 1 September of the year before the change is to take effect. That is, if Scottish Water wishes to initiate an interim determination, it must inform us by 1 September. Similarly, if we wish to initiate an interim determination, we must inform Scottish Water by 1 September.

By mid-September, we will invite stakeholders to comment on the material change item that has triggered the interim determination. We expect that stakeholders will be able to comment on this by mid-October. We recognise that this is a relatively short timeframe. However, it is necessary to allow us to decide if any change in charge caps is required by 1 December.

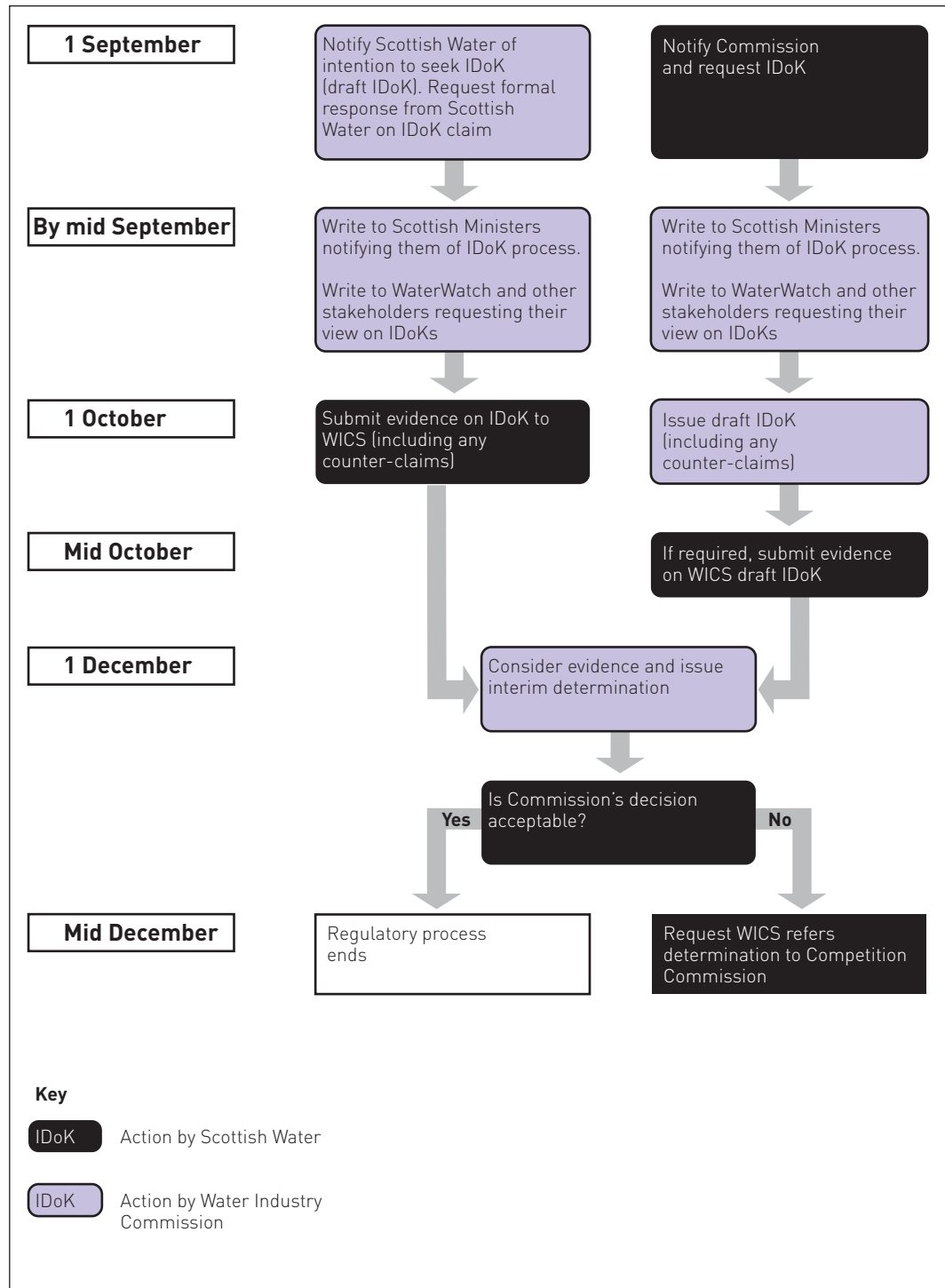
Any revisions to the charge caps that we set would apply from the April of the following year.

The interim determination process is summarised in Appendices 1 and 2.

Appendix 1: Interim determination process (1)



Appendix 2: Interim determination process (2)



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