

Stakeholder workshop 2: Calculation of price limits

Strategic Review of Charges 2010-14: 2009 workshops
Stirling, 5 February 2009

Programme for the morning...

A short overview of the price review process

Update on progress to date and events in 2009

Overview of our approach to calculating price limits

Your views and questions

Programme for the morning...



A short overview of the price review process

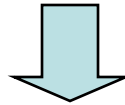
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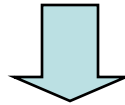
Your views and questions

The price review process focuses on delivering value for money for customers. The process can be summarised in three high level steps....

1. Ministers set objectives for the industry over the regulatory control period, and define the principles of charging that must be followed.



2. Scottish Water proposes how it will deliver these objectives, and the financing it will need to do so.



3. We scrutinise Scottish Water's proposals and set final caps on prices that finance Scottish Water to deliver the Ministers' objectives at the lowest overall reasonable cost.

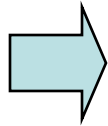
At the end of the process, we are able to determine the following:

1. Limits on the amount Scottish Water can charge household customers annually between 2010-14.
2. The 'default tariffs' that licensed suppliers in the newly competitive market are required to offer all business and public sector customers in Scotland.
3. Limits on the wholesale price Scottish Water can charge retail suppliers of business and public sector customers.

The final outcome is a regulatory contract setting out what Scottish Water must achieve and the financial parameters in which it must do so.

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Good progress has been made in the last 3 years. Significant developments to date include:

Methodology consultation. We consulted on how we planned to calculate price caps during 2007 in a formal written consultation process. We also held 8 workshops. Our conclusions are available on our website.

Principles of charging. During 2007/08 Scottish Ministers consulted on the principles of charging that should underpin the review. In May 2008, Ministers issued a draft statement requesting:

- Exemptions for voluntary organisations and churches to be maintained.
- Full cost recovery and geographical harmonisation.
- Further movement to cost reflectivity.
- Stable prices (if the Commission deems possible).

Scottish Water's first draft business plan. On 30 May Scottish Water submitted its first draft business plan for the 2010-14 period. We provided Scottish Water with guidance about the form and type of information we require.

In the plan, Scottish Water proposed:

- Real term price reductions for the generality of customers.
- Matching the efficiency of the three best companies in England and Wales in 2007/08 by 2014.
- Further significant improvements in customer service (as measured by the Overall Performance Assessment).

We also provided Scottish Water with feedback on the plan. We welcomed many of its proposals. We've also held workshops to discuss uncertainties and differences ahead of the second draft plan submission.

In 2009 the review will gather momentum ahead of our announcement of final price caps in November...

SW submits second draft business plan 13 March 2009

Draft determination of price limits published 30 June 2009

Draft determination consultation closes 23 Sept 2009

Ministers issue directions 23 Sept 2009

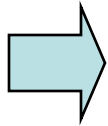
Final determination of price limits published 30 Nov 2009

Period for Scottish Water to accept final determination or appeal closes 31 Jan 2010

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Overview of our approach to calculating prices

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To calculate price limits, we plan to follow a two step process...

- The **first** step is to determine Scottish Water's financing requirements using a "building blocks" (or RCV based) approach.

We'll assess how much of Scottish Water's financing should come from public borrowing, and how much from customers.

- The **second** is to translate Scottish Water's revenue requirements from £s into annual average percentage price caps.

To do so, we'll need to understand how many customers Scottish Water serves. We'll also need to take into account the introduction of competition.

We plan to use a ‘building blocks’ approach to determining Scottish Water’s revenue requirements

- The “building blocks” (or RCV based) approach to price setting is widely used by other regulators, eg Ofwat, ORR, but tailored to the regulated organisations’ circumstances.
- The 2005 price review was the first time we adopted the approach – we believe it offers a more transparent way of setting prices and it allows us to make direct comparisons with England and Wales.
- In 2007, we consulted on using this approach again. Most respondents to our consultation agreed it was appropriate.

A 'building blocks' approach involves the following elements...

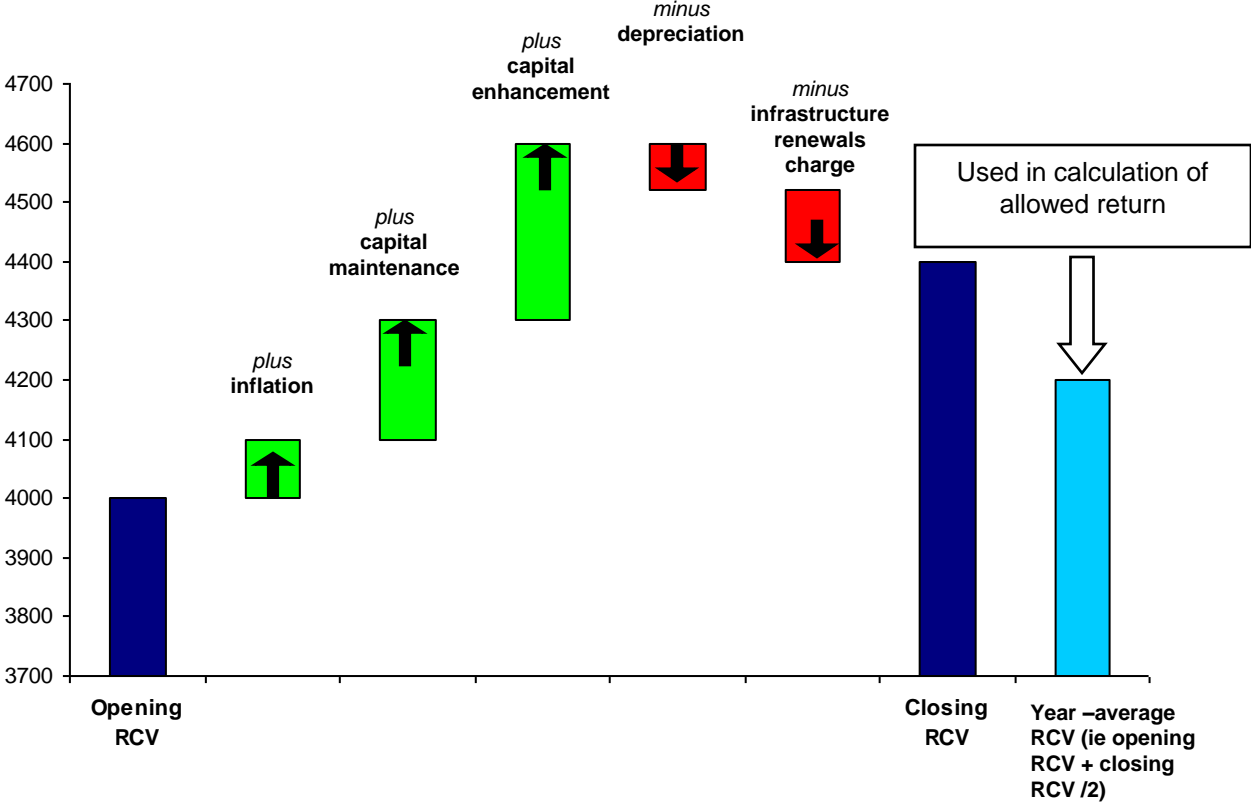
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| <p>An allowance for operating costs</p> | <p>This covers Scottish Water's running costs and takes into account assumptions about future efficiency improvements.</p> |
| <p>An allowance for depreciation</p> | <p>This takes into account that the value of Scottish Water's non-infrastructure assets will decline over time.</p> |
| <p>An infrastructure renewals charge</p> | <p>This allowance is similar in principle to depreciation, but is calculated separately to take into account the longevity of Scottish Water's infrastructure assets (dams, pipes and sewers etc).</p> |
| <p>An allowance for the costs of Public Private Partnership (PPP) contracts</p> | <p>Scottish Water currently has 9 PPP contracts in place for the provision of sewerage services. We allow Scottish Water funding to pay for the costs of the contracts.</p> |
| <p>Return allowed on the RCV</p> | <p>In 2005 we determined a 'Regulatory Capital Value' (RCV) for Scottish Water's assets. At the end of regulatory periods, the RCV is adjusted to take into account additions to, and the depreciation of, Scottish Water's assets.</p> <p>Over the regulatory control period Scottish Water is allowed to earn return on its RCV – the 'cost of capital' – and this is factored into its financing.</p> |

We'll focus on the return allowed on the RCV and PPPs today and discuss the first three of these in more depth at later workshops.

We calculated a starting RCV for Scottish Water in 2005, we now need to adjust it to take into account changes during the current regulatory period...

- The RCV is a measure of the value of a company's assets. In 2005 we set an initial RCV for Scottish Water by using the comparator approach first used by Ofwat.
- We set the initial RCV at a level sufficient to allow Scottish Water to finance its functions on a sustainable basis.
- We now need to 'roll forward' Scottish Water's RCV to take account of how it has changed over each year of the current regulatory control period - for instance by adding new assets and deducting depreciation.

Rolling forward the RCV looks like this...



We allow Scottish Water to earn a rate of return on the 'rolled forward' RCV...

- In the private sector, a capped rate of return (or cost of capital) is calculated based on market conditions – the regulator makes an allowance for the cost of debt, and the cost of equity.
- The allowance takes into account that lenders and shareholders both face risks in investing in a water company and should be compensated for it. For instance, shareholders receive dividends.
- As Scottish Water is in the public sector, borrowing is provided by the Scottish Government at a defined rate. The Government is also Scottish Water's only shareholder. This presents us with two challenges:
 - How do we calculate the equity portion of the rate of return?
 - How do we find an appropriate balance between revenue from borrowing, and revenue from customers?

In our methodology consultation, we presented the equity issue in terms of risks...

- We proposed that in order to finance its functions, Scottish Water should earn a return on its RCV that is sufficient to recover all its costs. This should include the costs of unforeseen events inherent in operating a water and sewerage service.
- We asked whether Scottish Water faces operational risks any different to the English and Welsh companies.
- We proposed that if Scottish Water did not, the allowance for risks faced by shareholders in the rate of return calculation should be similar to that allowed in England and Wales.
- We highlighted one important difference – Scottish Water's shareholder, the Government, does not currently take a dividend.

We also considered the issue of balancing revenue from borrowing with revenue from customers...

- Borrowing allows water companies to better smooth the cost of investing in assets across their lifespan.
- Borrowing needs to be used in a sustainable way:
 - Too much borrowing helps keeps prices down in the short run, but creates a large burden for future customers to pay back.
 - Too little borrowing in the short term may mean that current customers are paying too much towards assets that they don't realise the full benefit of.
- We proposed that using the financial ratios applied in England and Wales would help us ensure that Scottish Water was financed in a sustainable way.

Another ‘building block’ in our financing calculation is an allowance for Scottish Water’s Public Private Partnerships...

- PPPs were used in the late 1990s to finance major improvements in environmental compliance without recourse to public expenditure.
- Evidence suggests that they provided good value at the time, relative to the three former water authorities.
- Growing evidence suggests that they are not such good relative value today, because Scottish Water has reduced its own costs.
- We consulted on whether PPPs be subject to an efficiency target at the next price review.
- Respondents generally did not support efficiency targets—recognising that Scottish Water could face difficulties renegotiating inherited contracts. We suggested instead that Scottish Water should use all the contractual levers it could to maximise value for money.

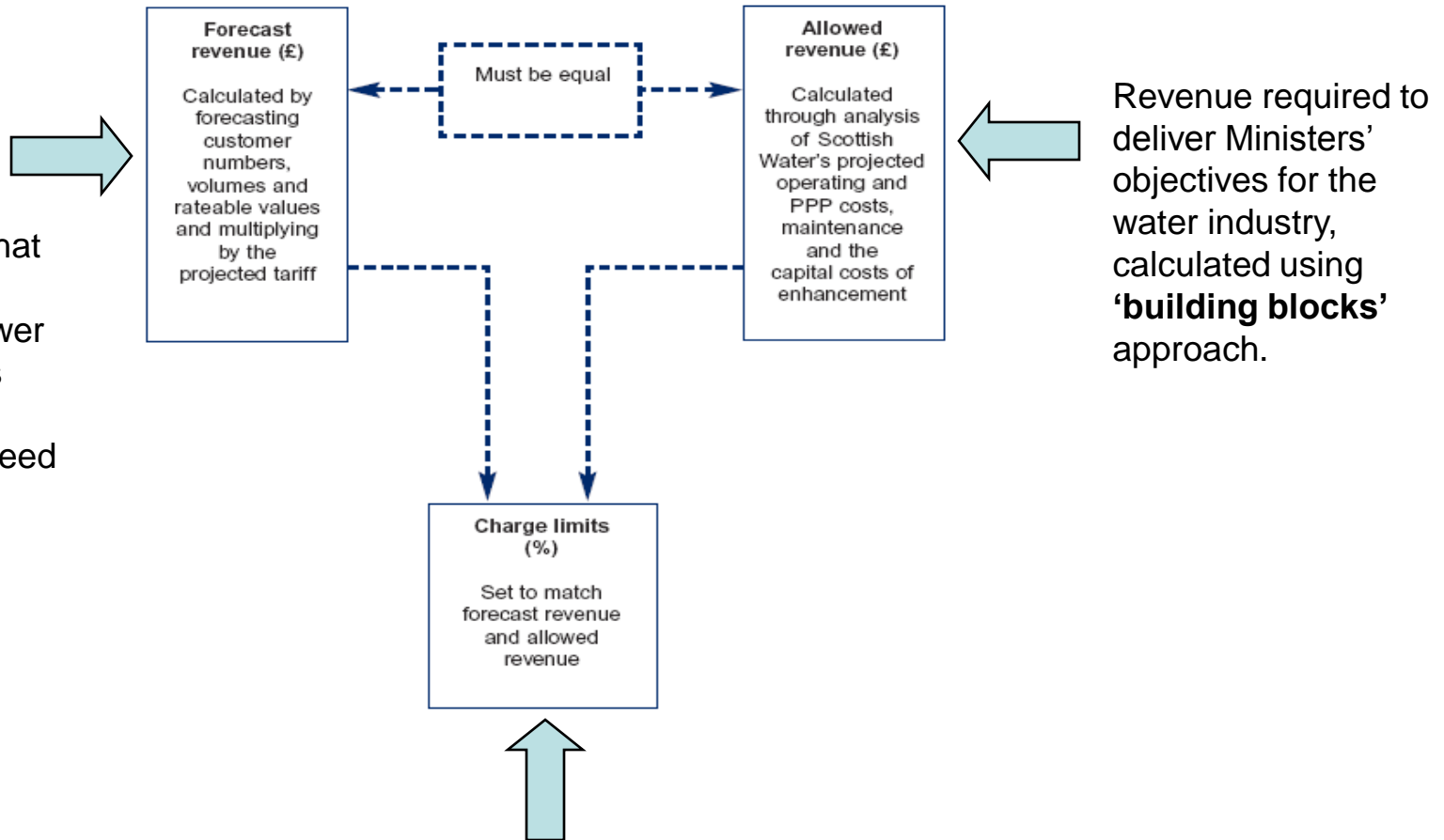
Once we have determined Scottish Water's revenue requirements, we translate them into charge caps by considering the size of Scottish Water's customer base....

- To calculate price limits we need to understand how many customers Scottish Water has in the present, how many it will have in the future, and what their consumption will be.
- The size of the customer base we assume will ultimately affect price caps - the higher the customer base we assume, the lower price caps will be, and vice versa.
- However, if we predict incorrectly, we could find that Scottish Water collects more or less revenue than we allowed for.
- We also need to take account of Scottish Water's role as a wholesaler – we need to predict a non-household customer base in order to allow Scottish Water to recover its wholesale costs.

In many ways it is a balancing act...

The assumed **customer base** impacts on the charge caps set.

The higher a customer base that the Commission assumes, the lower that charge caps (and therefore customer bills) need to be.



Charge caps are set consistent with the lowest overall reasonable cost of delivering Ministers' objectives

We plan to calculate the customer base using the following information.

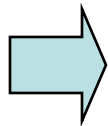
- Figures from local authorities and the General Register Office for Scotland to calculate the household baseline.
- Figures from the Central Market Agency to calculate non-household customer numbers.
- We will make an allowance for underlying growth, and any specific growth allowed for in Ministers' objectives – for instance to alleviate development constraints.

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**For more information on the price review please go
to:**

**[www.watercommission.co.uk/view_future_prices.
aspx](http://www.watercommission.co.uk/view_future_prices.aspx)**