Strategic review of charges 2010-14: stakeholder workshops 2009

Discussion paper 2: Calculating price limits

Welcome to our second stakeholder workshop of 2009 on the strategic review of Scottish Water's charges for 2010-14. Later this year we will determine caps on: the amount Scottish Water can charge household customers; the 'default tariffs' that suppliers in the newly competitive market must offer business customers; and limits on the wholesale price Scottish Water charges retail suppliers.

This workshop is the second of eight designed to explain the high level issues we will encounter in the final stages of the price setting process. It focuses on the approach we will take to ensuring that is sufficiently financed to deliver ministers objectives during 2010-14 and in particular, the financial tools we have available to do so.

This paper provides some context to the issues we will be discussing. We welcome your views and any questions you may have.

Background to financing Scottish Water

As a publicly owned utility, Scottish Water is financed to perform its duties in two ways: revenue from customers' bills; and borrowing from the Scottish Government. It does not have access to private equity or capital markets in the same way as the English companies.

Historically, the Scottish water industry has found it difficult to find an appropriate balance between funding from borrowing and revenue from customers. In 2001, when the first full strategic review was carried out, the three former water authorities were borrowing more than they could pay back. This meant that whilst customer charges were being kept lower than they would otherwise have been, a huge burden of debt was being created for future customers to pay back in higher bills.

During 2002-06, the industry went through a difficult transitional period in order to return to financially sustainable position. Some customers experienced price increases, and Scottish Water was required to make substantial improvements in efficiency. However, by 2006, the industry had successfully transformed itself from one that owed more than it was worth, to one that is now has an enterprise value greater than its total debt. This is good news for the future of industry and its customers.

The 2005 review considered in more depth how to reflect risks in the way Scottish Water was financed, and introduced a new 'building blocks' approach to financing. At the last workshop, we discussed some of the governance initiatives taken in 2005 to help protect customers from risks, for instance, the notion of a hard budget constraint and the creation of a gilts buffer. These initiatives were an important part of Scottish Water's overall financial package. Risk, governance and financing are generally factors that are very closely linked and a change in one factor will affect the others.

We propose to continue to use such an approach for the 2009 review.

How the 'building blocks' approach to price setting works

The building blocks approach is similar to that used for the privatised companies in England and Wales. It has also been used in the gas and electricity industries. It has the advantage of being very transparent and allow for robust comparisons with England and Wales.

The main 'building blocks' used to determine financing requirements are:

An allowance for operating costs	This covers Scottish Water's 'running costs' and takes into account assumptions about future efficiency improvements.
An allowance for depreciation	This takes into account that the value of Scottish Water's non-infrastructure assets will decline over time.
An infrastructure renewals charge	This allowance is similar in principle to depreciation, but is calculated separately to take into account the longevity of Scottish Water's infrastructure assets (eg pipes etc).
An allowance for the costs of Public Private Partnership (PPP) contracts	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.
Return allowed on the RCV	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. 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.

We also make allowances for tax and a current cost working capital adjustment.

Some issues in more depth

It is important that we determine an appropriate balance between financing Scottish Water through public borrowing, and financing Scottish Water using revenue from customers. In doing so, we need to consider:

- How do we make sure that customers do not pay too much or too little?

- How do we make sure that borrowing is not too high or too low?

- How do we allow for the risk of something going wrong that is beyond Scottish Water's control, but will impact its costs?

- Should we take account of the fact that Scottish Water does not have dividend receiving shareholders, if so, how?

A key element of balancing these factors is determining an appropriate level of return (cost of capital) on the RCV. In England, the cost of capital allowed by Ofwat is calculated based on assumptions about the cost of debt (which comes from private capital markets) and the cost of equity (remuneration for shareholders for risking their money in the company).

However, in the absence of private shareholders and sources of borrowing for Scottish Water, we could potentially take a different approach. We asked stakeholders about this issue in our methodology consultation. We set out our view that as Scottish Water performs broadly the same functions as water companies south of the border, it should face the similar risks. Therefore its cost of capital should be broadly the same. Stakeholders generally agreed with this principle.

We also considered the importance of financial ratios in determining Scottish Water's financing. Using a building blocks approach has the advantage of allowing us to calculate many of the financial ratios that are important to the English and Welsh industry. These ratios are used by Ofwat and the English and Welsh companies to gauge their financial health. They are also subject to the objective scrutiny of private lenders and investors. We proposed that Scottish Water's compliance with relevant ratios would be a further indicator that an appropriate balance between risks, customer revenue, and borrowing had been struck.