

## Financial tramlines

**This note gives an outline of our ‘financial tramline’ proposals for monitoring and sustaining Scottish Water’s financial health, and our expectations for 2015-20.**

### Key messages

The financial tramlines are an essential feature of the new regulatory framework. They ensure that Scottish Water maintains an appropriate level of financial strength over the medium to long term.

The approach also ensures that customers benefit as quickly as possible when Scottish Water finds alternative ways to deliver the required improvements.

The Customer Forum should reach agreement with Scottish Water on how and when customers should benefit from outperformance by Scottish Water.

### Introduction

This note outlines our proposals for ensuring that financing for Scottish Water remains sustainable over the longer term for customers, government and Scottish Water as a business.

Our proposals include an important role for the Customer Forum in reaching agreement with Scottish Water on how and when customers should benefit from the proceeds of outperformance.

### Overview of the proposals

Scottish Water and the Commission are introducing a new framework for monitoring Scottish Water’s financial performance. Under this framework, financial performance is measured against an acceptable range for key measures of financial strength. These ‘financial tramlines’ will complement the current suite of high-level performance indicators.

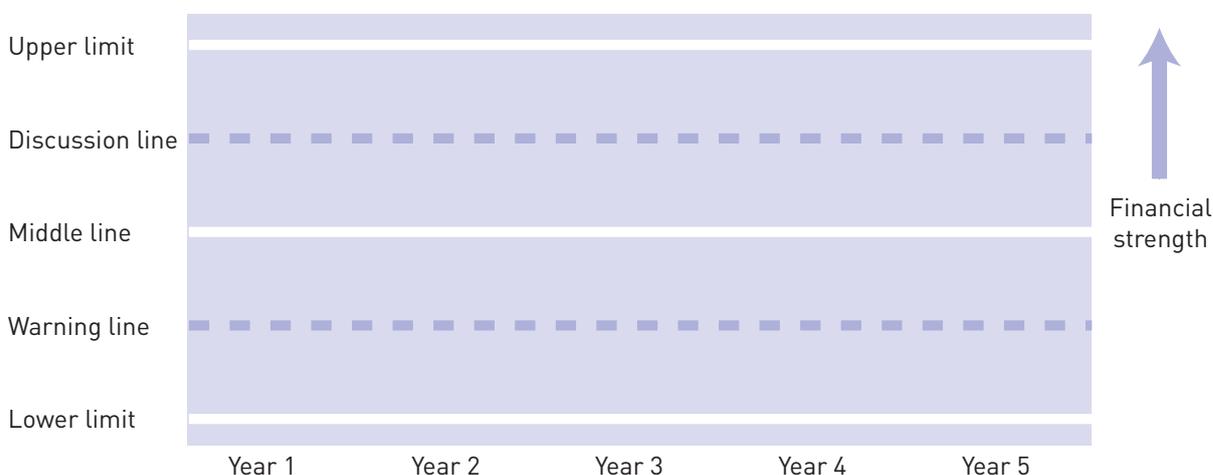
This approach to monitoring financial strength allows for year-on-year fluctuations in external economic circumstances. It is also consistent with the approach for monitoring performance in other areas, such as the Overall Performance Assessment (OPA).

Scottish Water will have flexibility to perform between the upper and lower limits of these financial tramlines. We have built a number of checks into the system, for example to ensure that there is early warning of declining financial strength. Once current and forecast performance exceeds a particular level within the acceptable range, Scottish Water will be expected to start sharing the benefits of its outperformance with customers. Similarly, below a particular level, management will set out in its Delivery Plan how and when performance will improve; this may involve an ‘interim determination of charges’, if appropriate.

The financial tramlines will be derived from cash-based financial ratios. They will be set at a level which will ensure that Scottish Water remains financially sustainable in the long term – irrespective of its precise position within the acceptable range.

## Note 7: Financial tramlines

As the figure below shows, the financial tramlines will be symmetrical around the middle line.



We have agreed with Scottish Water the measures of financial strength that will be used. There will be two main measures, called 'cash interest cover II' and 'ratio of funds flow from operations to debt', and a secondary measure, called 'gearing'. These ratios are all used by credit rating agencies as indicators of financial health<sup>1</sup>.

We have also provisionally agreed with Scottish Water the values that should be used for each of the lines shown on the figure above.

Line	Cash interest cover II	Ratio of funds flow from operations to debt	Gearing
Upper limit	2.20	13.0%	50%
Discussion line	2.05	12.4%	
Middle line	1.90	11.75%	
Warning line	1.75	11.1%	
Lower limit	1.60	10.5%	55%

In cash terms, the range between the upper and lower solid lines represents around £100 million a year.

<sup>1</sup> Further technical details can be found in our methodology.

## How the tramlines work

Scottish Water's financial performance in any given year, as indicated by its position in the tramlines, will determine if and when any action is required.

### **Middle line**

In order to maintain relatively stable prices during the price control period, Scottish Water would be expected to begin the price control period with the position as at 31 March 2015 and exit the price control by 31 March 2021 on the middle line.

If its performance relative to the regulatory settlement improves, in other words if it outperforms that settlement, its financial strength will increase towards the discussion line. It will be free to retain the savings that it generates whilst its financial strength lies between the middle line and the discussion line. Similarly, if it underperforms but its financial strength remains above the warning line, then no action will be taken.

### **Discussion line**

If Scottish Water's financial strength reaches this line, and is forecast to remain above this for the remainder of the price control period, the company would begin discussions with the Customer Forum to decide how the outperformance is used. It could be used, for example, to reduce charges, provide additional customer service improvements or build up the financial reserve.

Outperformance would be shared at Scottish Water's discretion at this point, provided its financial strength did not exceed the upper limit.

### **Upper limit**

If Scottish Water's financial strength reaches the upper limit, and is forecast to remain there for the remainder of the price control period, the company would use the proceeds of outperformance over that limit to the benefit of customers. At this point, the outperformance would automatically be shared with customers. The formula for determining the proportion of any outperformance to be shared with customers will be agreed with the Customer Forum at the start of the price control period.

In the event that performance declines rather than improves, Scottish Water's financial strength will decrease towards the warning line.

### **Warning line**

The purpose of the warning line is to provide an early signal that financial performance has declined. Scottish Water would explain in its Delivery Plan how and when performance will improve. This may involve an interim determination of charges, where appropriate. The intention of the Delivery Plan is to assure the Commission, the Scottish Government and the Customer Forum that performance will not worsen. The Commission would comment on the Delivery Plan.

### **Lower limit**

We would review Scottish Water's performance and take appropriate action to ensure that the company is in an appropriate financial position in future. Such a response might entail, for example, a reduction in the capital investment programme, an increase in customer charges or potentially, in exceptional circumstances, even a revision to the position of the financial tramlines.

Scottish Water would have to breach two of the three financial ratios for the responses outlined above to be triggered.

## The Customer Forum's role

We expect there to be three areas in which the Customer Forum could engage with Scottish Water:

- discussing with Scottish Water and the Scottish Government the processes by which outperformance will be shared if the upper limit is reached and is forecast to be sustained;
- discussing with Scottish Water and the Scottish Government the scope, if any, to share outperformance when financial strength reaches, and is forecast to remain above, the discussion line; and
- discussing the possible linkage of management incentives to the amount of outperformance gains that are shared with customers.

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