Strategic Review of Charges 2010-14: Summary of discussions at stakeholder workshop 1 on the financing of Scottish Water

Held on Thursday 12 April in Stirling

Present from the office of the Water Industry Commission

John Simpson	Director of Analysis
Harriet Towler	Corporate Affairs Manager
Judy Tait	Analytical Assistant

Stakeholders present

Mike Donaghy	World Wildlife Fund
Deborah Downie	Shareholder Executive
Rosemary Greenhill	Scottish Executive
Tom Harvie-Clark	Scottish Executive
Jim Lugton	Scottish Council for Voluntary Organisations (SCVO)
Tim Martin	Shareholder Executive
Paddy McNamarra	Scottish Executive
Michael McVeigh	Ernst & Young
Gary Niven	Scott Moncreiff
Gerard O'Loan	NHS Scotland
Belinda Oldfield	Scottish Water
David Rae	North British Distillery
John Sawkins	Waterwatch
Ian Smith	Waterwatch
John Telfer	Scottish Water
Bryan Wallis	Water UK

Opening remarks

Stakeholders were welcomed to this first workshop for the 2010-14 price review. It was explained that this workshop, which preceded the publication of the Commission's methodology consultation for the review, would focus on how the Commission should approach the future financing of Scottish Water, and the associated issues of governance and incentives.

It was noted that the Commission hopes to capture the views of as many stakeholders as possible before publishing its methodology. Attendees were invited to raise questions throughout and comment on a confidential basis.

Several attendees raised the issue of the **language** the Commission intended to use during the review to explain its work. It was noted that the issues the review covers are necessarily complicated, but at times the language used was not always accessible to stakeholders.

One attendee also sought clarification as to how the **introduction of competition** would impact the review. It was noted that this review would take account of the new regime by setting three types of price cap:

- A cap on the charge Scottish Water can make to its household customers for water and sewerage services.
- A cap on the charges Scottish Water can make to retailers for providing wholesale water and sewerage services to the retailers' (non-household) customers.
- A default tariff which retailers must offer to non-household customers.

Key issues discussed

1. An overall approach to risk

Premise for discussion

There are various elements of **risk** that could affect Scottish Water's operation – drought, public health issues, pollution, asset/process failure, terrorism, accidents, health and safety issues, regulatory change. Some risks can be predicted by Scottish Water and effectively managed. Other risks exist that are outside Scottish Water's control and are unforeseen.

How and to what extent should these unforeseen risks be accounted for in the price review? WICS could assume that the risks for Scottish Water were similar to those for water companies in England and Wales. Would this be a correct assumption to make? In principle the risks should be the same, but could actions by interest groups change the risk?

Issues raised

One attendee noted that there were major risks associated with the current assumptions made about the quality of information on Scottish Water's **customer base** - errors currently exist in the regional assessors' databases, while the rate of domestic non-payment is higher in Scotland, and the statistics provided by Scottish Water for the number of non-household properties is not consistent.

One member noted the importance of understanding that managing and responding to risk carries costs implications. Who should carry this burden – customers? Ministers? And if Scottish customers are required to carry a different burden of risk to customers in England and Wales, a very clear explanation as to why would be needed.

One member noted that whilst Scottish Water may face the same operational risks as the English and Welsh companies, its faces other risks, for instance **legislative and political change** – would these be factored in, and if so how? Would there be benefit in an external agency, for instance a **credit rating agency** making an independent assessment?

One attendee noted that ultimately, Scottish Water has to do as Ministers ask. Should the policy **behaviour of Scottish Water's owners** be factored into any risk assessment?

One attendee suggested that any approach to assessing risk taken by WICS, or any external agency WICS may employ, should be consistent and aligned with the methods of other regulators.

One attendee noted that any risk assessment for the 2010 – 14 period would use information obtained in 2009, that is not current (2007) risk. Would this discussion better take place now?

It was noted that a wider discussion regarding risk, and who should carry the **cost burden of risk**, would need to take place prior to the price review. One attendee asked when and where should that discussion take place.

2. Setting Prices

Premise for discussion

At the last price review WICS introduced the **"building blocks"** approach towards price setting in the Scottish water industry for the first time. Should WICS continue to use this approach?

Issues raised

Attendees did not raise any issues with this proposal. However one attendee commented that the social offsets for a public company should be included in the approach to assessing revenue.

3. Cost of Capital

Premise

To finance its functions Scottish Water should earn a return on its RCV sufficient to recover all its costs. How best to assess the **long-run cost of operational risk**? By using **financial ratios** developed by credit agencies to help form a view? By using market information on the cost of operational risk, in a relevant way?

Issues raised

One attendee noted that using **market information** was a justifiable means of assessment.

One attendee commented that there should not be a large disparity between the approach taken by WICS and any other comparable regulators. A significant discrepancy in the answer reached would bring into question the appropriateness of the approach taken.

One attendee raised the omission of **hedging mechanisms**, which are not taken account of. It was noted that it is not currently possible for Scottish Water, as a recipient of public expenditure to engage in hedging activities.

One attendee commented on the extent of Scottish Water's **historic debt** and the rates had been undertaken – would there be benefit in re-financing this debt?

Attendees noted the Commission's statutory duty to set price caps consistent with the "lowest overall reasonable cost" of delivering ministerial objectives. One attendee questioned if there was a difference between "reasonable" and "achievable" and whether, in view of income forgone by means of non-payment, this was an important distinction.

4. Changes to Scottish Water's Regulatory Capital Value (RCV)

Premise for discussion

Scottish Water's RCV is an indicator of Scottish Water's value. Rolling forward the RCV is a necessary element of the "building blocks" approach to price setting - it takes into account how Scottish Water's RCV has changed over time for instance through asset additions and deprecation.

Issues raised

Attendees recognised that **changes to the RCV** were a necessary component of the building blocks approach to price setting and raised no further issues.

5. Financial Modelling

Premise for discussion

Should WICS retain its existing financial model, but adapt it to account for changes in the industry since the last price review? How can stakeholders become engaged in the modelling process?

Issues raised

One attendee from Scottish Water noted the importance of Scottish Water being engaged fully in this process and its willingness to do so.

It was noted a formal sharing programme will be rolled out by WICS to ensure that this happens, in time for Scottish Water to use it to produce the first draft of the business plan.

6. Gilts Buffer

Premise

The gilts buffer was established as part of the last price review as an "insurance policy" for customers. It is to be funded from any Scottish Water out-performance proceeds. Is this a good idea, in principle? How big should this buffer be allowed to grow?

Issues discussed

One attendee asked if any risk involved in this would be born out of Scottish Water's reserves.

One attendee asked if the gilts buffer could eventually pay a **dividend**, and if so, who would be the beneficiary of it? It was noted that at present, Ministers choose not to take a dividend from Scottish Water's outperformance. Therefore those monies can either be re-invested in gilts, invested directly in the industry or be given back to customers in the form of a rebate.

One attendee questioned the benefit of investing in out-performance when more customer benefit could be derived from refinancing historic debt. Furthermore, the **customer rebate** from a gilts buffer would be inconsequential. If customers were to benefit significantly from any such rebate then the **public perception** would be that the price settlement had not been strict enough and the regulator had not done its job.

One attendee emphasised that a gilts buffer had the clear advantage of being an entirely transparent way to demonstrate publicly whether and to what extent Scottish Water had out-performed and to what extent it had.

7. Incentives

Premise:

Good progress was made at the last price review to ensure that Scottish Water's interests were closely aligned with that of its customers - Can current incentives be strengthened? Should the rolling incentive mechanisms used by Ofwat be employed? Could they be simplified?

Issues discussed:

One attendee raised a concern that Scottish Water may not wish to outperform at the start of a price review period to avoid the proceeds of outperformance being captured.

One attendee responded that Scottish Water has a statutory remit to deliver ministerial objectives during the regulatory control period. There is no incentive for it to delay investment until the end of the period as can happen in England and Wales.

It was highlighted that until the gilts buffer and/or a reserve had been built up, the Scottish Executive and Scottish Water's customers would effectively act as a buffer.

One attendee questioned how any notion of outperformance could be reconciled with the fact that half of Scottish Water's output leaks from the network? It was noted that whilst **leakage** was an issue, any benefit from reducing leakage must be offset against the cost of doing so.

One attendee questioned how the sum to be spent on gilts would be determined. A process for doing so would need to be established.

Another attended pointed out that a clear **definition of outperformance** is needed before any monies can be paid into the gilts buffer. This issue would need to be considered for the current review period.

One attendee emphasised that there was at present a rigorous process in place to monitor the delivery of ministerial objectives and manage change. The **Output Monitoring Group (OMG)** chaired by the Scottish Executive, is a cross-regulatory group which provides a transparent and objective assessment of Scottish Water's investment delivery performance. There was also an on-going process of sign-off of projects by the appropriate regulator.

Public Private Partnerships (PPPs)

Premise for discussion

PPP costs are a significant component of Scottish Water's expenditure. PPPs appear to have represented good value for money for Scottish Water's customers historically. However, in recent years Scottish Water has improved its operating efficiency significantly – do PPPs still represent a better value alternative, if not, should PPPs be subject to an **efficiency target** at the next price review?

Issues raised

One attendee questioned the approach proposed in the Commissioner's draft determination during the last price review, commenting that the costs of Scottish Water's PPPs could not be directly compared to the costs of running non-PPP sites in England and Wales. WICS should acknowledge that the PPPs are contractual arrangements and charges eg the rate paid per cubic metre for processing sewage cannot be changed. The contracts would need to be **renegotiated**. Given that the contracts were competitively tendered, they should already represent best value. There is no guarantee that renegotiation would produce a better deal for customers. The tenders included for the risks involved over a long operational period.

One attendee questioned the rationale for introducing an efficiency target – Was it because WICS did not believe that customers should be required to pay costs in excess of what would be incurred by the alternative simply because a PPP contract existed? If so, could WICS reasonably demonstrate that this was in fact the case? Or was WICS suggesting that the contacts in themselves could be better managed?

One attendee highlighted that whether these contracts, and the services that Scottish Water offered as a whole represented value for money would only be tested when the retail market is opened to **competition**.

One attendee questioned whether the issue of the **ownership** of Scottish Water would be included in the methodology consultation. It was noted that the consultation would raise the issue of how an owner should behave and any impact on exposure to risk.

END

*The Commission attaches significant importance to stakeholder workshops and would welcome any further comments or feedback that interested parties may have. Comments should be sent to Harriet Towler (**harriet.towler@watercommission.co.uk** or 01786 430200).*

*A discussion paper, issued prior to this workshop and providing further context is available on the Commission's website at **www.watercommission.co.uk**.*

A further three stakeholder workshops will be held prior to the publication of the Commission's consultation on the methodology for the price review.

Methodology volume	Publication date	Workshops
1. Financing Scottish Water	10 May 2007	26 July 2007
2. Customer revenue and levels of service	31 May 2007	10 May 2007 16 August 2007
3. Operating costs	28 June 2007	31 May 2007 30 August 2007
4. Capital expenditure	26 July 2007	28 June 2007 20 September 2007