

# Strategic Review of Charges 2010-14: Summary of discussions at stakeholder workshop 5 on the financing of Scottish Water

Held on Thursday 26 July in Dundee

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Present from the office of the Water Industry Commission

David Simpson	Commission member
Alan Sutherland	Chief Executive
Katherine Russell	Director of Corporate Affairs
Harriet Towler	Corporate Affairs Manager

Stakeholders present

Keith Haig	Water Industry Commission Audit Committee member
Tom Harvie-Clark	Scottish Executive
Campbell McLundie	Scott Moncrieff
Phil Murray	Glasgow City Council
Gerard O'Loan	NHS Scotland
Belinda Oldfield	Scottish Water
David Rae	North British Distillery
Ian Smith	Waterwatch
Scott Walker	National Farmers Union Scotland
Bryan Wallis	Water UK

## Opening remarks

Stakeholders were welcomed to this fifth workshop for the 2010-14 price review. It was explained that this workshop, which followed the publication of Volume 1 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. The workshop was designed to assist stakeholders who planned to respond to the Commission's consultation. Questions were invited throughout.

Attendees were updated about the timeline for the Strategic Review. It was noted that the timeline had been revised from that of the last review, allowing Scottish Water more time for business planning. The process of setting objectives, costing the delivery of these objectives in business plans, and finally scrutinising these costing before factoring them into prices was designed to ensure that customers received value for money.

It was noted that it was important that stakeholders and customers provide their views on both the current methodology consultation and the draft determination of charges. Furthermore, the Commission encouraged both those who supported its approach and those who favoured alternatives to respond to its consultations, as it allowed the Commission to take a balanced view of opinions.

## Key issues discussed

Volume 1 of the methodology consultation focuses on incentives and risk. It seeks stakeholders and customers views on the following issues:

- 1. Do respondents agree that the level of operating risks faced by Scottish Water are broadly similar to those faced by companies south of the border? If not, how are they different and how should this be allowed for in prices?**
- 2. Do respondents agree that using proper comparisons with England and Wales remains the most effective way to regulate Scottish Water? If not, how should we set prices and measure the levels of service?**
- 3. Given that we have duty to promote the interests of customers, are we taking sufficient steps to protect customers from unnecessary risks? If not, what other steps should we be taking?**
- 4. Do respondents agree with our use of the RCV, gilts buffer and rolling incentives?**

### 1. Approach to operating risks

#### *Premise for discussion*

All water and sewerage companies face risks to their operation. These risks include (but not exhaustively) drought, public health issues, regulatory change, accidents, asset and process failure. Is it reasonable to assume in price setting that Scottish Water faces the same operational risks as the companies in England and Wales? If Scottish Water faces different risks, what are they? And, how material are they?

Furthermore, if Scottish Water faces different risks, how should we take account of them? WICS propose that if a risk lies within the control of Scottish Water's management it should be Scottish Water's owner, the Scottish Executive that carries the cost burden. If the risk is outwith management control, then customers should bear the cost of that risk.

#### *Issues raised*

One attendee questioned whether a change of ownership presented a significant risk for Scottish Water, and one that was not faced by the companies in England and Wales. Another attendee suggested that regulatory change may also be a risk that differentiated Scotland from England and Wales. It was noted that the governance arrangements for Scottish Water do distinguish it from the English and Welsh companies – could it be assumed that the Scottish Executive would act as an owner in the same way that the owners of the English and Welsh companies did? However, was the risk of regulatory change faced by the English and Welsh companies different to that faced by Scottish Water? The risk of a change in policy could be a distinguishing factor, but was it material?

One attendee questioned whether the owner's or the regulators' approach to risk was a material factor. For instance, if either were risk adverse, would customers pay more as a result? Another attendee noted that theoretically, Ministers could formulate very risk adverse objectives – what would WICS' response be if they viewed these objectives as not being in the interests of customers?

Another attendee noted that Scottish Ministers, the Drinking Water Quality Regulator, Scottish Environment Protection Agency, Waterwatch Scotland and WICS were all focussed on protecting the interests of customers in the Scottish water in some way. To date, no organisation had taken a dramatically contradictory view of how this should be done.

One attendee questioned whether the restriction on Scottish Water accessing private capital markets presented a significant risk for customers. It was noted that whilst public expenditure was available, no additional risk was presented to Scottish Water. Furthermore, other options for funding investment could be explored such as Public Private Partnerships and leasing assets. It was important though that customers should not be expected to pay more as a result of Scottish Water not being able to access private capital.

## **2. Comparisons with England and Wales**

### *Premise for discussion*

WICS uses comparative information with England and Wales to gauge how well Scottish Water is performing. WICS also use this information as an indicator of how well Scottish Water could perform in the future. WICS currently uses information from England and Wales in relation to operating costs, capital expenditure, customer service (in the form of Ofwat's Overall Performance Assessment (OPA)) and financial ratios (as an indicator of financial 'good health').

Is it reasonable that WICS continue to make such comparisons? Are there differences between Scotland and England and Wales that should be taken into account? Are there other ways of putting Scottish Water's performance into context that WICS should consider?

### *Issues raised*

One attendee questioned whether WICS' benchmarking could be extended to include how operating risks are managed, for instance, is best practice being followed?

One attendee commented that when the OPA was first introduced into Scotland they were concerned that it would not encourage the right behaviours from Scottish Water. Indeed, they had been concerned that it would simply encourage Scottish Water to embed its existing performance. However, Scottish Water has embraced the OPA and used it to demonstrate continuous improvements in its performance.

One attendee supported WICS' use of benchmarking, but suggested it could be extended to beyond the UK. Another attendee noted that Ofwat performs a similar exercise in its international comparators report, but that gaining directly comparable information that is robust enough to factor into a price review would be difficult.

Another attendee noted that Waterwatch Scotland and the Consumer Council for Water were considering the feasibility of undertaking research into what customers pay for water and sewerage services across the world.

One attendee noted that the election manifesto of the Scottish National Party had proposed the abolition of the council tax in favour of a local income tax. Scottish Water currently bill household customers through the council tax system - what would the impact of this change be on household customers? It was noted that an advisory group was being established by the Scottish Executive to explore this issue. Whilst it was not clear what the impact would be should this change occur, issues such as how Scottish Water would bill customers in the future and the impact on its costs would need to be considered. Furthermore, the Water

Services etc (Scotland) Act 2005, which sets out the framework for competition, defines customers eligible for competition as those not billed for water and sewerage through the council tax system. Whether household customers would become eligible for competition upon the abolition of council tax by default would need to be considered.

Another attendee questioned whether the range of discounts for water and sewerage applied through the council tax system would be continued, and what the impact would be on affordability if they were not.

### **3. Protecting customers from risk**

#### *Premise for discussion*

At the Strategic Review of Charges 2006-10, a number of steps were taken to protect customers. These included the establishment of a hard budgetary constraint on Scottish Water – Ministers confirmed that customers should not pay twice for the same output. A 'gilts buffer' – indexed linked securities - was also agreed. Once established this could provide the finance to cover unexpected shocks, helping to limit customers' exposure to price increases.

To what extent should customers be insulated from the effects of operational risks on prices? Should a size limit be placed on the gilts buffer? If so, how should WICS think about the appropriate size?

#### *Issues raised*

One attendee noted that the Scottish Executive does not take a dividend from Scottish Water as shareholders would in a private company. Customers benefit from this arrangement.

Another attendee noted that private lenders factor the risk to their funds into the rate at which they lend. Shareholders are rewarded for investing in companies by receiving a dividend. As the Scottish Executive lends at public sector rates, and does not receive a dividend, is it therefore reasonable to expect it to bear the same risks as private lenders?

One attendee questioned whether the change of ownership of some English and Welsh companies, for instance being purchased by banks, had changed the focus of the company away from customers.

Attendees noted that the gilts buffer would be built up from the proceeds of outperformance. One attendee questioned whether customers would be given a rebate from the gilts buffer. Another attendee questioned whether the gilts buffer would be used as a source of funding for other areas of the Scottish public sector, or whether it would be invested back in the water industry. Furthermore, would Scottish Water's management be able to access the gilts buffer?

One attendee questioned how payments into the gilts buffer would be determined. If Scottish Water outperformed one year, but underperformed the next, how would this be taken account of? Could payments be made into the gilts buffer annually, or could the extent of Scottish Water's outperformance only be accurately assessed at the end of each four-year regulatory control period?

Another attendee questioned how the £50 million reserve allowed for at the last price review would be used? It was clarified that this reserve was additional public borrowing that could

be accessed by Scottish Water in the event of a shock beyond management control. It acted as further protection for customers against operational shocks.

#### **4. Use of a Regulatory Capital Value (RCV) approach to price setting and rolling incentives**

##### *Premise for discussion*

At the last strategic review, WICS introduced a ‘building blocks’ approach to price setting and determined a RCV for Scottish Water. The building blocks approach to price setting is commonly used by other regulators, eg Ofwat, ORR, but tailored to the regulated organisations’ circumstances. WICS believes it offers a more transparent method of price setting.

Ofwat have strengthened the incentives for the English and Welsh companies by using rolling incentive mechanisms. They allow the companies to retain the benefits of outperformance for a number of additional years before being passed to customers/ However, Ofwat’s rolling incentives tend to require complicated rules and calculations.

Is it appropriate that WICS continue to use an RCV based approach to price setting? Should WICS introduce rolling incentives for Scottish Water? Can a simpler mechanism be devised?

##### *Issues raised*

Attendees noted that a key debate for the next price review would be the extent of the return Scottish Water is allowed on the RCV, rather than the size of the RCV.

One attendee questioned whether rolling incentives would result in prices being higher than necessary. For instance, if rolling incentives allow the regulated organisation to retain some of the proceeds for outperformance for longer, did it mean that efficiencies made were not being reflected in lower prices, or being passed into the gilts buffer? However, another attendee suggested that providing a rolling incentive could lead to higher efficiencies than would otherwise have been achieved. This would ultimately be to the benefit of customers.

Another attendee questioned whether such an incentive would be effective for an organisation that is publicly owned and does not have shareholders.

#### **5. Other issues – Public Private Partnerships**

##### *Premise for discussion*

PPPs were used on 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 authorities. However, growing evidence suggests that they are not such good relative value today, because Scottish Water has significantly reduced costs.

Should PPPs be subject to an efficiency target at the next price review? Or are they inherited contractual arrangements beyond Scottish Water’s control?

##### *Issues raised*

One attendee questioned whether Scottish Water had the option to buy its PPP sites. Another attendee questioned if PPP sites were purchased by Scottish Water, who would need to be satisfied that these sites are fit for purpose?

Another attendee questioned if there was a legal basis for Scottish Water to renegotiate its contracts. It was noted that it was usual to refinance PPP contracts once sites had been operational for some time and the risks associated with set up had passed. Cabinet Office guidance existed regarding how the proceeds of re-financing should be shared between the PPP consortium and the customer. It was not clear if Scottish Water's PPPs had been refinanced. One attendee questioned whether placing pressure on Scottish Water to refinance its PPP contracts was appropriate – would it prejudice Scottish Water's ability to negotiate new competitive PPP contracts in the future?

**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](mailto: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](http://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.***

<b>Methodology volume</b>	<b>Publication date</b>	<b>Workshops</b>
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