Methodology Information Paper 2: Setting prices

Introduction

This information paper provides an overview of the Commission's proposed approach to setting prices. It begins by discussing financial sustainability and the importance of protecting customers from the effects of unexpected events. It explains that Ministers have undertaken that customers will not pay twice for the required level of service. The paper then outlines how these safeguards for customers are reflected in the Commission's approach to financing Scottish Water. The paper concludes with a description of our use of the regulatory capital value.

Financial sustainability

In November 2001, in the Strategic Review of Charges, the then Water Industry Commissioner provided advice to Ministers on the charges and revenue necessary to fund the water industry in Scotland for the period from 1 April 2002 to 31 March 2006. In his Strategic Review the Commissioner commented that:

"This Review seeks to address the customer's need for a sustainable Scottish water industry. It recommends a revenue cap that should place the industry on a sound financial foundation, where there will be a balance between the financing demand placed on this, and future, generations."[1]

In November 2006 we, the Commission, reiterated this view:

"We consider that it is important to emphasise that we have not achieved this price stability at the expense of future customers. Scottish Water will end the regulatory control period in a strong financial position – if it meets the terms of its regulatory contract."[2]

Our obligations in respect of financing

We have a duty to ensure that Scottish Water has sufficient resources to enable it to deliver Ministerial objectives at the lowest reasonable overall cost. Our allowance for financing costs should take account of the risks that need, to be managed by the owner and/or management of Scottish Water. We consider the operational risks that the owner of the Scottish water industry must ensure are managed, to be broadly similar to those

[1] Strategic Review of Charges, November 2001, Foreword.
[2] The Strategic Review of Charges, November 2006, Executive Summary, p7.

that exist south of the border. As such, we believe that it is appropriate to set a comparable cost of capital to that allowed for in England and Wales. In coming to this conclusion we have noted that Ministers have undertaken that customers will not pay twice for the required level of service. This guarantee replicates the protection provided to customers by the regulatory framework south of the border.

The price setting formula

A standard approach to price setting uses 'building blocks', with the regulator making allowances for operating costs; depreciation (both capital maintenance and the amortisation of enhancement capital expenditure); tax; changes in working capital; and the cost of capital.

At the last review we moved towards an RCV method of price setting. We introduced an RCV for Scottish Water. Scottish Water receives an appropriate rate of return on this RCV. We set these such that Scottish Water was financially sustainable. We used the same financial ratios that Ofwat had applied in its 2004 Price Determination for the companies in England and Wales to measure the financial strength of Scottish Water.

Efficient investment in new assets is added to the RCV. Depreciation (reflecting the costs of using existing assets) reduces the RCV.

The RCV is a proxy for the current value in use of Scottish Water's above-ground asset base. This value will change over time to reflect the ageing of assets (the cost of which is recognised by the depreciation charge) and investment in new assets.

The rate of return is the cost associated with managing and financing the above-ground asset base. The cash cost of replacement is covered by the depreciation charge.

Revenue is calculated as follows:

Return allowed on the regulatory capital value +
allowable operating costs +
depreciation on non-infrastructure assets +
the infrastructure renewals charge (IRC) +
the costs of Public Private Partnership (PPP) contracts.

The product of the RCV and the allowed rate of return gives the total return allowed on the RCV. This ensures that customers only contribute

towards those assets that have been created and which are providing a benefit to customers[3].

The move towards the RCV method of setting prices affects only our approach to meeting the costs of new and existing assets. We do not believe that it has any immediate material impact on the prices faced by customers, on the resources available to Scottish Water, or on the implications for public expenditure. The changes were designed principally to allow greater transparency. They bring the approach to price setting for Scottish Water into line with that for the English and Welsh water and UK energy sectors. As such, we are able to make more direct comparisons in financial ratios than were previously possible.

In a private company the difference between the total return on the RCV and the net interest costs belongs to the owner of the company. This can either be re-invested or returned to the owner by way of a dividend. In a wholly debt financed company, the choice is between reinvestment, improving financial strength or perhaps returning a dividend to customers. In the case of Scottish Water, this whole difference is re-invested. The un-leveraged portion of the RCV (ie the RCV less total debt) has many of the same properties as would equity owned by the customer. But this 'equity' does not currently pay a dividend.

Issues arising

If the Scottish Executive continues to make debt finance available at lower rates (while accepting responsibility for a failure of Scottish Water to achieve the required outputs), we propose that the difference between the commercial cost of debt and the public sector cost of debt should be allocated to the "gilts buffer" at the end of each financial year.

It has become common for regulators to adjust the level of prices so that the regulated company complies with the financial ratios that the credit rating agencies recommend. In its 2004 Final Determination, Ofwat set a cost of capital but then made some upward adjustments to prices to improve the compliance of certain companies with the financial ratios advised by the credit rating agencies. Some commentators have criticised what they consider to have been little explanation of how Ofwat made the adjustments. In effect the need for an adjustment implies that the cost of capital that has been allowed for is insufficient for a particular company. This raises the question as to how that company is different from the sector average and whether this difference is within the control of the

[3] Information paper 4 – describes our proposed approach to setting a cost of capital. Information paper 5 describes the technical aspects of the RCV.

board of the company. There is also a question as to whether there should be similar downward adjustment in the “building blocks” answer if the financial strength of a company exceeds that required by the rating agencies and that this is not the result of prudent management action (for example, foregoing dividends).

Related Documents

‘The Strategic Review of Charges 2002-06’, Water Industry Commissioner for Scotland, November 2001.

‘The Strategic Review of Charges 2006-10: The draft determination’, Volume 5, Water Industry Commissioner for Scotland, June 2005.

‘The Strategic Review of Charges 2006-10: The final determination’, Water Industry Commission for Scotland, November 2005.

‘Efficiency incentives for public sector monopolies – the case of Scottish Water’, Beesley Lecture, Alan D A Sutherland, London, November 2006.