

Methodology information paper 7: Gilts buffer

Introduction

This information paper explains how we, the Commission, propose to operate the gilts buffer. It sets out how we intend to assess outperformance and the process by which the outperformance will be transferred to the gilts buffer. The paper also outlines possible approaches on how we could determine the appropriate size of the gilts buffer. The paper concludes by explaining how we propose to release resources from the gilts buffer.

At present, Scottish Water's customers are more immediately exposed than customers in England and Wales to the operational risks of the business. In England and Wales, the presence of private equity acts as a significant shock¹ absorber, and as a result protects customers. A good example of this is the cost of the Yorkshire drought in 1995 (approximately £250 million), which had to be absorbed by the equity holders of Yorkshire Water. In Scotland, Scottish Ministers have agreed to meet the costs of similar operational shocks. However, there may be operational shocks that are outside the control of management. The costs of such shocks would not be met by Ministers and the gilts buffer would protect customers from their potential price implications..

In the Strategic Review of Charges 2006-10 we proposed that any outperformance in the regulatory contract should be transferred into a 'gilts buffer'. This ensured that Scottish Water was subject to a tight budgetary constraint. An important consequence to note is that Scottish Water should borrow in line with the profile established in the final determination, unless it invests at a materially faster or slower rate. We also proposed that, although the buffer would clearly belong to Scottish Water (and its customers), it would be important that decisions to release some or all of this reserve were agreed by Ministers and the Commission.

Analysing outperformance

We will assess Scottish Water's outperformance on a yearly basis and define the amount that should be transferred into the gilts buffer. We intend to do this by comparing Scottish Water's net debt position at the end of each financial year with the net debt assumptions in price limits and include any difference in the buffer.

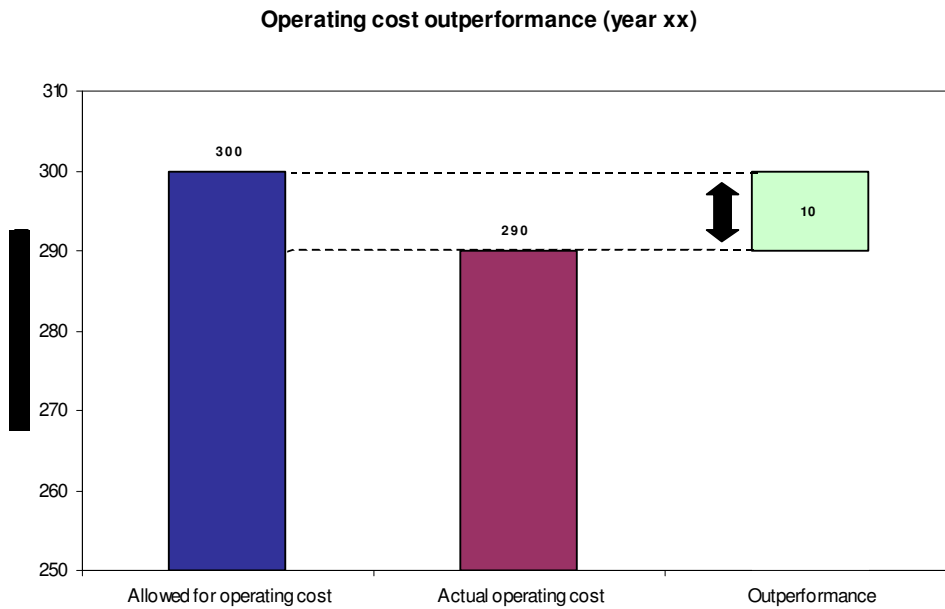
¹ Shock outside the control of management

Before determining the amount to be transferred, we will review whether Scottish Water had delivered the forecast levels of service for the assessed year.

We will make any necessary adjustments to recognise the impact on net debt due to the differences between Scottish Water’s actual capital expenditure against our assumed profile in the price limits.

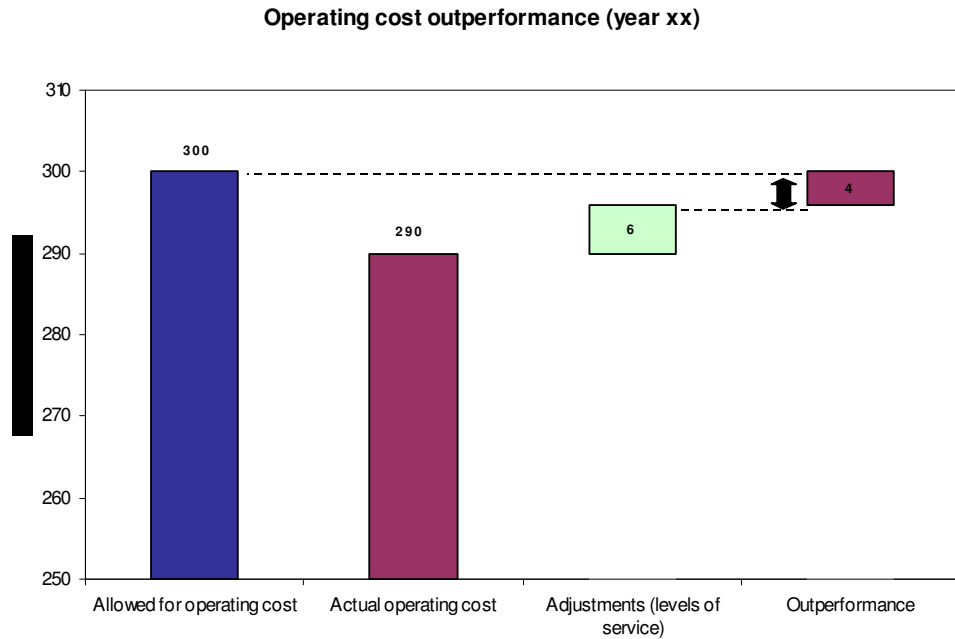
It should normally be straightforward to assess the extent to which Scottish Water has succeeded in bettering the assumptions in the price review with regard to operating or financing costs. This is shown in the following two worked examples.

Worked example 1: Outperformance calculation (with no adjustments)



In this example, the Commission allows for an operating cost target of £300m and Scottish Water outperforms that target by £10m. In this case, £10m would be added to the gilts buffer.

Worked example 2: Scottish Water spends less than the allowed for operating cost amount but fails in delivering the assumed levels of service



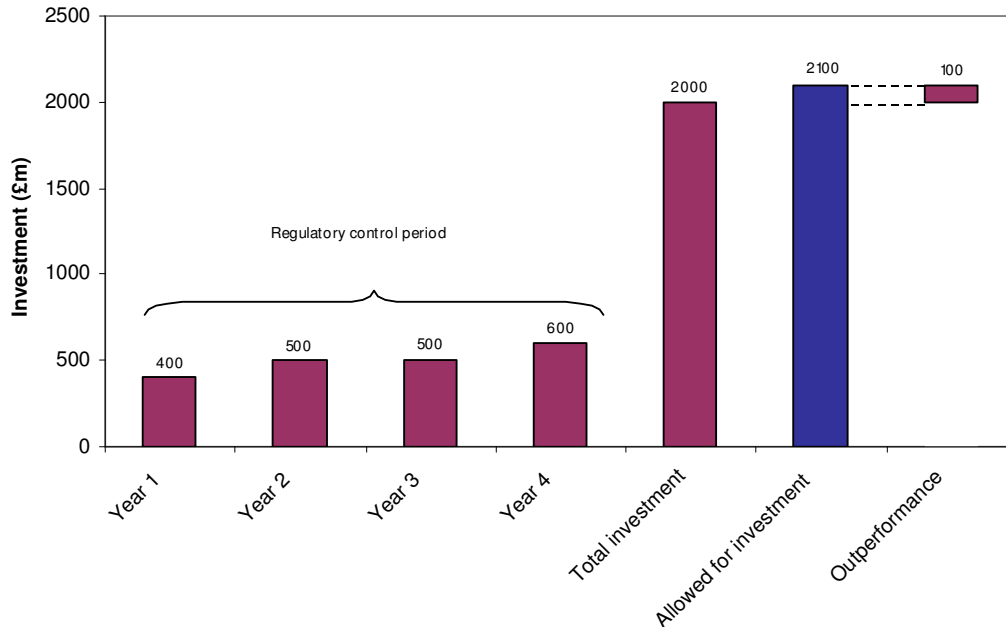
In this example Scottish Water has not delivered the levels of service. The Commission carefully analyses the costs of the shortfall in the level of service provided to customers. For the purposes of the example, we conclude that this shortfall would have cost £6m to address. As such, we reduce the original £10m outperformance by £6m. We therefore require that £4m be transferred to the gilts buffer.

Ministers set a number of objectives that Scottish Water has to deliver through capital expenditure by the end of a regulatory control period. In its determination of Scottish Water’s charges, the Commission allows for efficient capital expenditure to deliver the ministerial objectives. Ministers’ objectives are for the four year regulatory control period and, as such, definitive analysis of whether Scottish Water has out- or under performed in its capital expenditure programme cannot be completed until the end of the regulatory control period. It would therefore be prudent to delay any transfer to the gilts buffer resulting from performance in capital expenditure until financial year 2010-11.

Worked example 3 explains how he would deal with capital expenditure outperformance.

Worked example 3: Capital expenditure outperformance

Calculation of capital expenditure outperformance



In this example, Scottish Water delivers the ministerial outputs by spending £2bn and the allowed for amount is £2.1bn. In this case, the gilts buffer should increase by £100m during year 5. It is worth noting that the phasing of capital expenditure is not relevant to the assessment of whether Scottish Water has out-performed its regulatory contract. That is why only the regulatory period total can be used to calculate outperformance.

Size of the gilts buffer

We do not consider that the gilts buffer should grow without limit. Once the gilts buffer has reached a sufficient size to provide a cushion for an operational shock, we propose that any additional outperformance should be distributed back to customers. This would also be in line with the hard budgetary constraint.

We propose to use a number of different approaches to assessing the appropriate size of the gilts buffer for a company the size of Scottish Water.

The gilts buffer is in essence an 'insurance policy' for customers who could otherwise be exposed to substantial price fluctuations. As such, its size should depend on the operational risks faced by Scottish Water. We

could therefore determine the size of the gilts buffer by analysing a series of potential operational shocks (outwith management control), assessing their impact of these on Scottish Water's finances and assigning a possible likelihood for each of these events. These operational shocks can be intrinsic to the water industry (e.g. Yorkshire drought in 1995 or the leakage problems at Thames Water) as well as external (macroeconomic shock). We would then set the size of the buffer once all these events are analysed.

A simplified approach to the previous alternative could be to focus on one big known operational shock and link the gilts buffer size to this shock. For instance, if the Yorkshire drought cost shareholders £250m, how much would it cost to customers in Scotland if it suffered a drought of similar magnitude?

A third approach could be to analyse how Welsh Water dealt with these uncertainties. Given that Welsh Water does not have access to equity funds, it maintains 'committed'² credit lines from banks that could be used to meet the costs of an operational shock. The size of these credit lines could be scaled to the size of Scottish Water and we could therefore set the size of the gilts buffer accordingly.

A fourth approach would be to rely on financial ratios. Banks use ratios to assess the financial health of a company. Targets on financial ratios could also be taken as the banks' tests for debt repayment. For instance, the difference between the 'funds from operations/debt' ratio target of 13% and the 'retained cash flow/debt' of 7% could imply that in an eventual shock, equity holders could forgo their dividends and provide the company a cushion equal to 6% of their net debt (if a company had £3.3bn. of net debt, the potential amount forgone would be around £200m).

Changes in the buffer

The rules relating to transfers into and out of the gilts buffer are set out below.

Cash inflows

We propose to analyse Scottish Water's outperformance on a yearly basis and publish our conclusions in the Cost and performance report. Cash generated from any outperformance against the regulatory contract will be transferred to the gilts buffer.

² A committed credit line is a lending facility that guarantees a company that it will have access to those funds when required.

Our analysis will use Scottish Water's Annual Return and we would request Scottish Water to comment on our conclusions prior to publication. Table 1 sets out the annual timetable.

Table 1: Indicative dates for determining additions to the gilts buffer

Action	Indicative Date
Scottish Water submits Annual Return (i.e. year ended March 200X)	June 200X
WICS' analysis of Scottish Water's outperformance	June – August 200X
WICS formally requests Scottish Water to increase gilts buffer	September 200X
Scottish Water provides comments on WICS analysis	October 200X
Conclusions published in the Cost and Performance Report	November 200X
Scottish Water increases gilts buffer	January 200X+1

Cash outflows

The gilts buffer has been created in order to provide insurance to Scottish Water for events outwith management control (external shocks). Extreme events could happen at any time in the year and therefore the process should be flexible enough to address these needs. However, any outflow of money would need to be authorised by the Scottish Executive and the Commission.

The Commission proposes to agree to release resources if the costs incurred were outside the control of management. If a determined management could have avoided these costs, we believe that it should fall to the Scottish Executive to meet these costs.

Related documents

'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.