

Staff Paper 5

Public private partnership costs

This staff paper has been produced by our office to assist stakeholders in responding to the Draft Determination. The material reflected in this staff paper has informed the preparation of the Commission's proposed conclusions. However, this staff paper does not form part of the Draft Determination. Accordingly, this staff paper should not be relied upon as expanding upon or replacing anything contained in the Draft Determination.

5.1 Introduction

Scottish Water inherited nine public private partnership (PPP) wastewater treatment contracts from the three former water authorities. These contracts account for more than 10% of Scottish Water's current annual spending. The works that operate under PPP contracts treat around half of Scotland's waste water and dispose of around 80% of its sludge. The contracts are long term, and most are not due to expire until the 2030s.

This paper:

- outlines the Commission's approach to PPP at the last Strategic Review;
- explains the Commission's current approach;
- summarises Scottish Water's claim for PPP costs; and
- sets out the Commission's proposals on the level of PPP cost to allow for.

5.2 Approach in the last Strategic Review

In the last Strategic Review the Commission considered the PPP contracts in some detail. It concluded that while the contracts for the nine projects represented good value for money at inception, it was less certain that this remained the case. The Commission presented analysis that suggested that customers' bills were financing substantial and possibly excessive returns by equity holders in the PPP schemes. It therefore considered setting an efficiency target for the payments to PPP contractors. However, the Commission concluded that it could be argued that insufficient notice had been given to the PPP contractors of the intention to challenge them to provide

better value for money for customers. The decision was therefore made to delay the decision about setting an efficiency target for PPP to the next regulatory control period.

In the Final Determination 2005 Scottish Water's estimated PPP costs were allowed for without applying an efficiency target. In establishing the allowed for level of PPP costs an additional allowance was included to address the shortfalls in performance of these contracts relative to the level of service required by the Scottish Government's objectives.

5.3 Current approach

The Commission's previous analysis of the PPP contracts led it to consider that it would be in customers' interests to refinance the contracts or to renegotiate them to reflect reduced levels of revenue for the contractors. More recently, the performance of some PPP contractors has come into question. Scottish Water stated in its business plan that the performance of the Dalmuir waste water treatment works is problematic and the works has not complied with environmental standards. Furthermore, there are continuing customer complaints about odour from Seafield waste water treatment works. Scottish Water expressed concern in its first draft business plan that some of its PPP contracts are inadequately incentivised and structured to ensure delivery of its objectives, and stated that the risk of performance failure would increase as the contracts progress towards their natural end. Scottish Water therefore said that it intended to exploit any opportunities to restructure or buy out the contracts during the 2010-14 period.

The Commission had intended to support Scottish Water's position on possible refinancing, as it considered that refinancing should allow Scottish Water the maximum control over performance that would help it to deliver improved levels of service to customers. However, refinancing any (or all) of the PPP contracts would require considerable additional public borrowing. During 2008 it became clear that the level of public borrowing that the Scottish Government was likely to make available over the period 2010-14 would be significantly constrained. The Commission has therefore had to adapt its approach and assume that the contractual arrangements will not change during the next regulatory control period. It may be possible to revise this if finance were to become available through the Scottish Futures Trust.

5.4 Scottish Water's claim for PPP costs

Table 5.1 summarises Scottish Water's claim for PPP costs.

Table 5.1: Summary of Scottish Water's claim for PPP costs (2007-08 prices)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Contract costs	£122.4m	£122.3m	£122.4m	£122.6m	£122.9m	£122.6m
Changes to PPP charges	-	-£0.1m	£0.1m	£1.5m	£1.5m	£1.6m
New PPP charges	-	£0.1m	£0.1m	£0.2m	£0.6m	£0.7m
Rates and SEPA costs	£4.1m	£4.1m	£4.1m	£4.1m	£4.1m	£4.1m
Contract management	£1.3m	£1.3m	£1.0m	£1.5m	£1.0m	£1.0m
Total	£127.8m	£127.7m	£127.7m	£129.9m	£130.1m	£130.0m

5.5 The Commission's proposals

The constraints on available finance mean that the Commission considers that it should allow for the normal costs to Scottish Water of its PPP contracts. In assessing the level of cost, the Commission considers it necessary to allow for the additional costs of addressing shortfalls in the performance of contracts relative to the levels of service required by the Scottish Government's objectives. However, it does not propose to make any allowance to remedy failures on the part of PPP contractors to meet contractual performance standards. The Commission expects Scottish Water to manage its contracts pro-actively to ensure that there are no shortcomings in performance.

The Commission previously allowed for resources in the PPP allowance for improvements in odour control at the PPP works at Seafield. The Commission has now removed this amount from the allowance for PPP but allowed for the proposed direct investment in this area for odour improvement at Seafield. In so doing, the Commission has assumed that Scottish Water has taken account of and addressed the risks associated with the resulting confusion of asset ownership and management responsibilities of a PPP site.

The Commission proposes that PPP costs should not increase in real terms during the regulatory control period. However, it considers that it would be appropriate to allow £2 million per year to be used by Scottish Water to ensure that the PPP contracts meet current environmental standards and customers' expectations.

Table 5.2 summarises the proposals.

Table 5.2: Summary of proposed allowed for PPP costs (2007-08 prices)

	2010-11	2011-12	2012-13	2013-14
Contract costs plus rates and SEPA charges	£130.0m	£130.0m	£130.0m	£130.0m
Additional allowance	£2.0m	£2.0m	£2.0m	£2.0m
Total	£132.0m	£132.0m	£132.0m	£132.0m

5.6 Summary

The Commission considers that continuing the PPP contracts is not in customers' interests. There is however no alternative to current arrangements until such time as finance is available to allow Scottish Water to buy back the PPP assets. In allowing for PPP costs, it is assumed that Scottish Water will exert all possible contractual pressure on its PPP partners.