

## Section 7 – Finances

### Introduction

This section collects all financial inputs which determine Scottish Water's revenue requirement for the 2010-14 regulatory period. It also collects the main outputs of the model such as charge caps and reference ratios.

This section is divided into 3 areas:

- Base historic data
- Financial assumptions
- Outputs

The information to be input in the tables refers to Scottish Water wholesale with the exception of table 14 which contains current assumptions on the licensed retail industry (pre-input by the Commission).

Scottish Water should state in its commentary all assumptions made to complete the tables in this section.

### Guidance to Scottish Water

#### **Base Historic data (Tables 1 to 8)**

These tables contain historic financial information for the years 2006-07 and 2007-08. These include Regulatory accounts (Balance Sheet, Profit and Loss, Cash Flow, Working Capital, Tax, Embedded debt and expected depreciation on closing assets).

There are some minor amendments compared to the 2006-07 RAR's. The table definitions explain these changes.

Scottish Water should note the following:

**Table 8 Depreciation and amortisation of closing assets:** Scottish Water should provide a detailed explanation on how the expected MEAV depreciation on base assets has been calculated (Line 9).

Scottish Water should also ensure that the broad equivalence check outlined in the Commission's Methodology Information Paper 5 is met. The commentary should include a description of any adjustment required to meet the criteria.

#### **Financial Assumptions (Tables 9 to 16)**

These tables contain any assumptions that could affect the financial accounts for the period 2008-09 to 2017-18. Inputs in these tables are equivalent to those input in the Financial Model tables A1, A2, A3, A4, A5, A6, A7 and "allocation" respectively.

Scottish Water should note the following:

**Table 9 Inflation:** Inflation inputs refer to financial year averages. Information until 2006-07 has been input. Scottish Water should input its inflation forecast for 2007-08 onwards.

**Table 10 Financing:** Cost of capital assumptions are input in 'real' terms (i.e. net of inflation). Actual costs of financing assumptions are input in nominal terms.

Line 10 relates to the portion of the cost of equity that should have been distributed as dividends but may be foregone by the Scottish Government.

Line 11 relates to expected increase/decrease of the gilts buffer. Scottish Water should include any 2006-10 outperformance assumptions into the gilts buffer.

Line 12 is determined and input by the Commission and is the assumed closing RCV at the financial year end 2009-10.

**Table 11 Capital expenditure:** Capital expenditure should be split among Q&S2, Q&S3a, Q&S3b and 'other' capital expenditure forecast. Capital expenditure post 2013-14 should be included in the Q&S3b block. Q&S3b and Q&S3a investment is split between maintenance and enhancement. It is assumed that any Q&S2 and 'other' investment will be related to capital enhancement.

Scottish Water should also reconcile in its commentary the capital expenditure assumptions in table 11 against the information submitted in sections 5 and 6 of the Business Plan.

These asset life categories in Table 11 are the same as those used in the previous Strategic Review Financial Model as well as those used in Table M22 of the regulatory accounts.

**Table 13 Non-fixed assets:** Inputs on profit and loss items are in base year prices and Balance Sheet assumptions are in outturn prices.

In its commentary, Scottish Water should reconcile its assumptions on operating costs with those indicated in section 4.

Scottish Water should only include service fees in the PPP line. Any Scottish Water 'internal' costs should be included as operating cost (Line 2)

**Table 14 Licensed retail business:** Inputs have been given by the Commission and should not be changed. Scottish Water should include any comments about these inputs in its commentary.

**Table 16 Revenue allocation targets:** This table should contain the breakdown of the smoothed revenue among the revenue customer groups. This information can be extracted from the Financial Model.

### **Outputs (tables 17 and 18)**

These tables collect the outputs of the financial model.

**Table 17 Charge caps:** Scottish Water should include in Block A the 'calculated' charge caps from the financial model. These are the charge caps which match revenue from the 'building blocks' approach to the tariff baskets.

Scottish Water should use Block B if it decided to apply any 'smoothing' to the resultant charge caps in Block A. Scottish Water must explain the basis for this adjustment and justify its 'equivalence' to the revenue calculated charge caps.

**Table 18 Ratios and Debt outputs:** This table collects the resultant financial ratios (as well as usage available public borrowing) from the applied 'smoothed' charge caps.

## **Reporter Guidance**

The Reporter is asked to:

- review the rules adopted by Scottish Water for allocation of expenditure to asset life categories. The Reporter should indicate whether or not Scottish Water's procedures are reasonable, and whether staff involved in allocation decisions follows them.
- comment upon any differences from rules and procedures adopted in other submissions (particularly the Annual Return), consistency of the reported asset lives with those used for the calculation of depreciation profiles and those of assets and lives reported in the Annual Return.
- confirm or otherwise that the depreciation charge stated has been calculated using Scottish Water's rules on proportional allocation between purpose categories (specifically between base service and all enhancements).
- confirm or otherwise that Scottish Water's accounting rules used for depreciation on additions and work in progress (WIP) have been stated in the commentary and have been followed in the completion of the tables; and that Scottish Water has commented on asset life assumptions.
- confirm that the procedures set out in the commentary for the review of asset lives for both new and existing assets have been followed and the results of this review are reflected in the projections set out in the tables.
- confirm that the allocation of capital expenditure across asset life categories is consistent with the assumptions on the capital programme made elsewhere in the plan.
- comment on an exception basis where Scottish Water has not provided commentary on inconsistencies in asset lives and investment allocation between those used in previous years and those reported. Similarly he should comment on inconsistencies between engineering and financial judgements on asset lives and investment allocation.
- comment where judgements on asset lives and investment allocation made for engineering purposes are not fully consistent with those used for financial purposes.
- confirm that where changes have been made to MEA values and/or depreciation charges that these have been fully explained in the commentary. Confirm that the impacts on CCD charges have been accurately calculated.
- comment on the appropriateness of the approach to revaluation and assessment of remaining useful asset lives taken by Scottish Water.