Strategic Review of Charges 2010-14

Stakeholder information workshops 2009: Calculation of price caps

Stirling, 5 February 2009

Attended by

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Belinda Oldfield	Scottish Water
Gerard O'Loan	NHS national procurement
Alan Scott	Scottish Water
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Opening remarks

Stakeholders were welcomed to the second workshop of 2009 on the Strategic Review of Charges 2010-14. This workshop would primarily focus on how price limits are calculated, but attendees were welcome to raise any other issues they wished.

It was explained that strategic reviews were carried out in three key stages aimed at ensuring customers receive value for money:

1. Ministers set Scottish Water objectives to achieve over four year regulatory periods. Ministers also decide the principles of charging that should underpin the review.

2. Scottish Water sets out in two draft business plans how it intends to deliver Ministers' objectives.

3. WICS scrutinises Scottish Water's plans to ensure that they represent the best value for money for customers. WICS set limits on charges consistent with delivering these objectives at the lowest overall reasonable cost.

At the end of this process, WICS determines limits on the amount Scottish Water can charge households in each year of the regulatory control period. It also sets the 'default tariffs' that licensed suppliers must offer business and public sector customers in the competitive market, as well as limits on Scottish Water's wholesale charges to licensed suppliers.

It was explained that WICS intended to adopt a ‘building blocks’ approach to determining Scottish Water’s revenue requirements. This was an approach commonly used by other regulators, and allowed for comparisons with the English and Welsh companies.

WICS expected one component of the building blocks approach, Scottish Water’s depreciation, to be potentially higher than that of English and Welsh companies. This was due to the accounting practices adopted by Scottish Water. WICS noted it would need to take account of this, and one option it was considering was to set a lower return allowed on Scottish Water’s Regulatory Capital Value by a mitigating amount. It was noted that this would have no affect on the overall level of financing allowed.

In order to calculate a return on Scottish Water’s regulatory capital value, WICS would need to consider how much return should be allowed on Scottish Water’s debt, and how much return for Scottish Water’s shareholders (equity). It was explained that as a publicly owned organisation, the Scottish Government provided all of Scottish Water’s borrowing at a defined rate. It was also Scottish Water’s only shareholder, but chose not to take a dividend. It was this equity portion of the allowed return that presented WICS with a challenge to calculate.

WICS also needed to find an appropriate balance between funding Scottish Water from debt and using revenue from customers. Debt is commonly used in the water industry to spead the cost of new assets across their lifespans. Too little borrowing could mean that customers in the present pay too much for assets that they do not realise the full benefit of, too much borrowing could create too great a debt burden for future customers. WICS proposes using the financial ratios applied to the companies in England and Wales to find an appropriate balance and ensure Scottish Water’s continuing financial sustainability. Such an approach, however, relied on sufficient public borrowing to be available.

It was explained that once Scottish Water’s allowed for level of revenue had been calculated, this would be converted into price caps by balancing forecast revenue with forecast customer numbers. This required WICS to have accurate estimates of both Scottish Water’s household customers and the non-household customers supplied by licensed retailers in the competitive market.

WICS also expected to be required to unwind cross-subsidies relating to trade effluent. During the regulatory control period, it had come to light that trade effluent customers were paying bills lower than the cost of supplying them, resulting in non-trade effluent customers paying too much. This would be rectified when WICS calculated price caps for each customer group.

Overview of issues discussed

Reliability of customer information

One attendee asked how reliable the databases used to calculate customer numbers were. Concerns were expressed that if all customers were not captured by assessors then there could be ‘free loaders’. It was noted that the quality of customer information had improved significantly since the competitive market for non-household customers had been established. Business Stream and the Central Market Agency had undertaken a significant exercise to improve data quality. Also, retailers had an incentive to identify new customers.

This had meant that reported non-household customer numbers had slowly increased since the last review was carried out.

Depreciation

One attendee asked why Scottish Water's depreciation allowance was expected to be higher than the English and Welsh companies. It was noted that this was primarily for two reasons. The first was that Scottish Water's depreciation was calculated using standard accounting practices that helped to minimise its tax burden. The second was that the English and Welsh companies adopt a methodology called 'broad equivalence' to calculate depreciation. Doing so gave a more 'economic' measure of depreciation, however, it required accurate information about historical and future assets lifespans. Scottish Water did not yet have sufficient historical information to adopt this approach.

It was noted that the outcome for customers, that is revenue required would not be affected by the level of depreciation, as WICS would make adjustments elsewhere in the revenue calculation to compensate.

Pensions

One attendee asked whether WICS would be required to make any allowance for Scottish Water's future pensions liability. It was noted that pensions, like salaries, were taken account of in Scottish Water's overall operating expenditure allowance. It was a management decision for Scottish Water as to how these funds should be used.

Availability of public borrowing

One attendee asked if WICS was concerned about the availability of future public borrowing. It was noted that the availability of such borrowing had become less certain since the last review. It also seemed likely that there would be less flexibility for Scottish Water to decide how and when it would access use this borrowing during the regulatory next period. WICS believed that in order to prevent customers from paying more than their fair share in the next regulatory period, the Scottish Government would need to make a firm commitment to making borrowing available, or allow Scottish Water to access alternative sources of borrowing.

Another attendee questioned whether it was likely, as had been proposed by the Confederation of British Industry, that Scottish Water could be privatised to fund a new Forth road bridge. If so, would WICS be conducting its price review in such a way as to maximise Scottish Water's value. It was noted that WICS had no view on the ownership of Scottish Water, which was a matter for Government. WICS would be carrying out the price review in such a way as to ensure Scottish Water's continued financial strength. Adopting the financial ratios used for the English and Welsh companies was an objective and transparent way of doing so.

One attendee questioned whether it was significant that the Scottish Government did not take a shareholders dividend from Scottish Water. It was noted that there was little effect on Scottish Water's finances as to whether a dividend was paid out or re-invested. WICS was more concerned that whilst the Scottish Government carries all the risk of a shareholder, were it to take a reward in the form of a dividend, this would pass directly to the UK Treasury.

Unwinding trade effluent cross subsidies

One attendee questioned what the effect of unwinding trade effluent cross subsidies would be on Scottish Water's revenue. It was noted that there would be no effect on the overall level of revenue collected. However, customers who had previously paid too little for trade effluent charges would now be expected to provide a greater share of revenue. All non-trade effluent customers could expect to pay less, ceteris paribus. WICS would seek to minimise the incidence effects on those who would be expected to pay more, but aimed to unwind the cross subsidy within five years.

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