Stakeholder workshop 1: Financing Scottish Water

Why are finance and incentives important to Scottish Water's customers?

How Scottish Water is financed, and the incentives it is provided with are important to customers for two reasons:

- Providing appropriate incentives, whether "sticks" or "carrots", is a vital part of ensuring the challenges of the regulatory contract are met and the best outcome for customers is delivered.

- Safeguarding customers against undue risk of steep price increases.

If the level of financing is set too low, Scottish Water cannot respond to unforeseen events that have a significant impact on costs, without access to additional new cash. This might require an unexpected increase in bills. However, if the level of financing is set too high, bills will be unduly high and an unnecessary surplus of cash could be generated. Getting the level of finance right is therefore a key part of our price review. Taking account of unforeseen events implies that we need to understand the level of risk that Scottish Water runs.

Progress so far

In the last price review, good progress was made with a framework for managing risk and providing incentives. Ministers requested that customers should not pay twice for the same output. This effectively placed a **hard budget constraint** on Scottish Water – it has to deliver Ministers' objectives for the costs allowed for in the review. The review recommended, in addition to this "stick", that Scottish Water should be rewarded if it performed better than expected – a "carrot". We were pleased when Scottish Water and the Scottish Executive recently agreed a **bonus scheme** for senior management whereby bonuses are paid for only out of the proceeds of cost outperformance. This combination of incentives helps to ensure that Scottish Water's interests are aligned with those of its customers.

We recognised that during the review period, unforeseen events could happen that were beyond the control of Scottish Water's management. These shocks could impact on Scottish Water's costs. Therefore, we introduced a mechanism to conduct an **interim determination of prices** to enable Scottish Water to recover any additional costs which were demonstrably incurred beyond its control. However, we also recognised that interim determinations can create uncertainty and disruption for customers. As such, within the proposed price caps, the Commission secured the Scottish Executive's agreement that a **reserve** should be established. This reserve would be used in the event of an unforeseen shock to cover up to £50 million of costs. The Executive also agreed that a further "insurance policy" for customers should be established. This **gilts buffer** reduced the likelihood that customers will face major increases in prices because of unforeseen shocks.

Issues for the next review

A key issue for our methodology consultation will be how we assess the level of risk that is appropriate to factor into prices. Our initial view is that the experience of water and sewerage companies in England and Wales could offer useful indicators of the extent of risk, provided that operating water and sewerage services in Scotland carries broadly similar operating risks to operating the same services in other parts of the UK. Where financial markets are exposed to these risks, they may also offer useful indicators.

Is it reasonable to assume that Scottish Water faces the same operational risks as an English and Welsh company?

When we set out our proposals, we intend to ask stakeholders whether they think that there are other steps we could take to protect customers from unnecessary risks.

Issues in detail

We believe that in order to consult effectively with stakeholders, we will need to ask them to consider the following specific issues:

Setting prices – we intend proposing the continued use of a “building blocks” approach to setting prices.

Cost of capital – determining an appropriate cost of capital will require consideration of an appropriate level of gearing, the cost of debt and the cost of operational risk. Underpinning all of these assumptions will be our assessment of financial ratios that are consistent with the assessed risks.

Changes to the RCV (Regulatory Capital Value) – we intend proposing to roll forward the RCV to take account of differences between actual delivery of investment in the current regulatory period and our assumptions in the 2005 final determination, using the methods (‘logging up and down’) developed by Ofwat.

Financial modelling – we intend to ask stakeholders who have used our financial model for their views on how it could be improved. We plan to have the structure and logic (and ultimately the numbers) reviewed by an external auditor. We also plan to share the model, as it develops, with Scottish Water.

Insurance policies – the gilts buffer – we intend to put forward proposals on how the gilts buffer could grow, how it could be accessed and how large it should be, and will seek comments from stakeholders.

Incentives – we intend to propose measures to strengthen further the incentives provided to Scottish Water. This may involve the use of rolling incentives where prices allow for outperformance gains to be retained for a period.

Public Private Partnerships – We intend to consult on the possible application of efficiency targets for PPP annual expenditure.

We would welcome your views on each of the above, and whether there are any other issues we should consider as part of Volume 1 of the methodology consultation.