Stakeholder workshop 5: 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.

Stakeholders views at the first workshop

We held our first workshop on Scottish Water's financing and governance on 12 April. Amongst the wide range of issues discussed, we primarily sought stakeholders' views on our overall approach to risk and how this approach would impact on the various components of the price review. One of the overall themes of the discussion was whether the operational risks faced by Scottish Water were any different to those faced by the English and Welsh companies. We discussed how customers could be better protected from risks, and whether there were steps that could be taken to provide customers with an 'insurance policy'.

We also discussed how we should take account of Scottish Water's Public Private Partnerships (PPP) in the price review.

Some of the issues raised by stakeholders included the following.

- What are the cost implications of managing and responding to risk? Who should carry this burden – should customers pay for it through their bills or Ministers through additional public expenditure?

- What factors differentiated Scottish Water from the English and Welsh companies? Does Scottish Water face different legislative and political risks – how can these be taken account of?

- A gilts buffer had been established at the last price review. The gilts buffer would be built up from the proceeds of Scottish Water out performing WICS' expectations in the price review. This buffer acted as an insurance policy for customers against shocks. However, would this buffer ultimately pay a dividend, and if so, who would be the beneficiary of it?

- Furthermore, if the gilts buffer was large enough to pay a dividend, should Scottish Water be congratulated for its performance, or WICS berated for not setting challenging enough price caps?

- Did PPPs still represent value for money for customers? Were there ways in which WICS could challenge Scottish Water to increase the value for money they offered? Was it reasonable to set an efficiency target, or are the terms of inherited PPP contracts beyond Scottish Water's control?

The issues we are consulting on

On 10 May we published our first methodology consultation. We posed the following questions:

Do respondents agree that the level of operating risks faced by Scottish Water are broadly similar to those faced by companies south of the border? If not, how are they different and how should this be allowed for in prices?

How we approach this issue will have an important outcome on the price review. If there is a difference between the operational risks faced by Scottish Water and the English and Welsh companies, should this differential be reflected in our approach to the cost of capital and hence the prices Scottish customers pay?

Do respondents agree that using proper comparisons with England and Wales remains the most effective way to regulate Scottish Water? If not, how should we set prices and measure the levels of service?

By comparing Scottish Water with the English and Welsh companies, we are able to gauge how well Scottish Water is performing. These comparisons also give us an indication of how well Scottish Water could perform in the future. However, are there reasons why it is not reasonable to take such a comparative approach?

Given that we have duty to promote the interests of customers, are we taking sufficient steps to protect customers from unnecessary risks? If not, what other steps should we be taking?

Sudden operational shocks can impact on prices if no new cash is available to address them. Are we proposing to take sufficient measures to protect customers from shocks, for instance through the gilts buffer? Or by proposing that operational risks are broadly the same north and south of the border are we understating the risks Scottish Water faces?

Do respondents agree with our use of the RCV, gilts buffer and rolling incentives?

These are important components of our approach to setting prices. Scottish Water's Regulatory Capital Value (RCV) is the cornerstone of the 'building blocks' approach to setting prices that we propose to use. It is important that the RCV used in the review takes into account differences between actual delivery investment over the regulatory control period, and the investment we predicted would be made over that period in the last price review.

The gilts buffer is an important ‘insurance policy’ for customers in Scotland. However, in what circumstances should Scottish Water make payments into the gilts buffer – when it performs better than expected? And is there an appropriate limit on the amount that should be stored?

‘Rolling incentives’ are a mechanism that could be used to increase the onus on Scottish Water to outperform its regulatory contract. Would it be appropriate to link these rolling incentives to the gilts buffer?

In addition, we raised the question of Scottish Water’s PPPs. We noted that we intended to ask Scottish Water for evidence that it has attempted to negotiate lower bills for customers through refinancing. If this has not been the case, we may seek to impose an efficiency target on PPP expenditure.