Workshop

Stakeholder workshop 1:Financing Scottish Water

Strategic Review of Charges 2010-14: Methodology
Stirling, 12 April 2007

water industry commission FOR SCOTLAND

Key dates for the price review

Methodology consultation published	10 May –26 July 2007
Methodology consultation period closes	19 October 2007
SW submits first draft business plan	30 May 2008
Ministers issue guidance	30 September 2008
SW submits second draft business plan	13 March 2009
Draft determination of price limits published	30 June 2009
Draft determination consultation closes	23 September 2009
Ministers issue directions	23 September 2009
Final determination of price limits published	30 November 2009

Methodology consultation

- The methodology consultation will be published in 4 volumes during May, June and July.
- For each volume we will hold two workshops for stakeholders.

Volume	Publication date	Workshops
1. Financing Scottish Water	10 May 2007	12 April 2007 26 July 2007
2. Customer revenue and levels of service	31 May 2007	10 May 2007 16 August 2007
3. Operating costs	28 June 2007	31 May 2007 30 August 2007
4. Capital expenditure	26 July 2007	28 June 2007 20 September 2007

Key issues for Volume 1: Financing Scottish Water

- *How do we assess the level of risk that should be factored into prices?*

- *Should we use comparators for this assessment?*

- *If so, should we assume that Scottish Water faces the same operational risks as the English and Welsh companies*?

Issues in detail : Setting prices

A “building blocks” approach to assessing revenue could include:

Return allowed on the RCV
+
Allowable operating costs
+
Depreciation (on non-infrastructure assets)
+
Infrastructure renewals charge
+
Costs of PPP contracts
+
Tax

Issues in detail : Setting prices

- The "building blocks" (or RCV based) approach to price setting is often used by other regulators, eg Ofwat, ORR, but tailored to the regulated organisations' circumstances.

- SRC06-10 was the first time we adopted the approach – we believe it offered a more transparent way of setting prices.

- Most respondents to our last methodology consultation agreed it was appropriate.

- *Do you agree that we should continue to use this approach?*

Issues in detail : Cost of Capital

- In order to finance its functions, Scottish Water should earn a return on its RCV that is sufficient to recover all its costs. This should include the costs of unforeseen events inherent in operating a water and sewerage service.
- *How do we assess the long run cost of operational risk?*
- *Can we use financial ratios developed by credit agencies to help us form a view?*
- *Can we use market information on cost of operational risk in a way that is relevant to Scottish Water's circumstances?*

Issues in detail : Cost of Capital

If we adopt the standard approach, using a weighted average cost of capital (WACC):

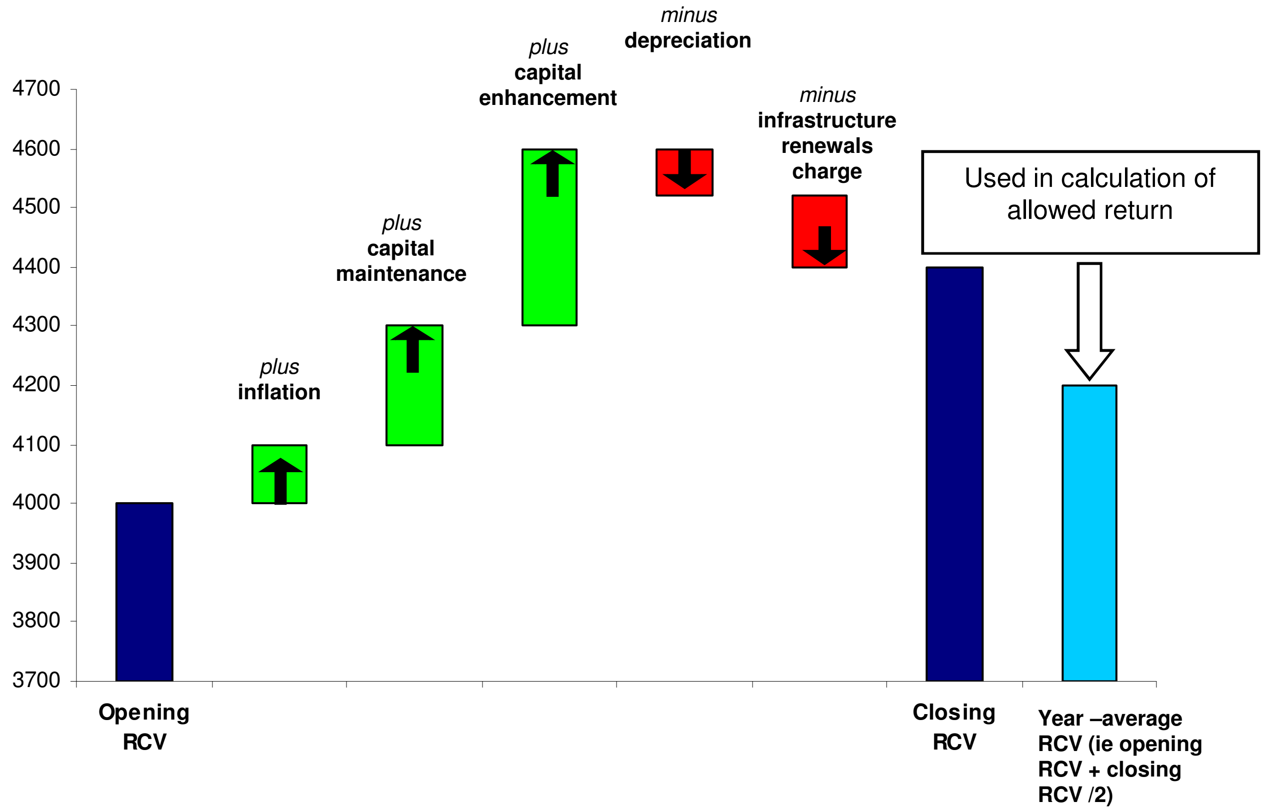
- *Should we have a view on the appropriate level of gearing (ie how much of the RCV is financed by debt)?*
- *Should we allow for the current cost of debt or the long run cost of debt?*
- *How do we calculate the rate of return that is required on the remainder of the RCV to cover operational risk?*

Issues in detail : Changes to the RCV

- Rolling forward the RCV is a necessary element of the "building blocks" approach to price setting.

- It takes account of how Scottish Water's RCV has changed over time for instance by adding new assets and deducting depreciation.

Issues in detail : Changes to the RCV



Issues in detail : Financial modelling

- The financial model underpins the review process. At the last review we developed a bespoke financial model which was subject to external audit.
- SRC10-14 will present a new challenge – taking into accounting the new framework for competition.
- *Do you agree that we should propose retaining the existing financial model, but adapt it to take into account changes to the industry?*

Issues in detail : Financial modelling

- The financial model is also a tool used by other stakeholders in the review process, particularly Scottish Water.

- *How can we best engage stakeholders in the process to develop the model?*

- It is important that the model is subject to external scrutiny to ensure that it is fit for purpose. We are considering seeking advice on best practice prior to changing the model. It will then be subject to an initial audit, followed by a final audit using actual figures for the review.

- *Is this proposal reasonable? Are there other issues we should be consulting on?*

Issues in detail : the gilts buffer

- The gilts buffer was established as part of the SRC06-10 as an “insurance policy” for customers. It will be built up from the proceeds of outperformance.

- Index-linked gilt edge securities will provide the finance to cover unexpected shocks, helping to limit customers’ exposure to price increases.

Issues in detail : the gilts buffer

- *To what extent should customers be insulated from the effects of operational risks on prices?*

- *What size limit should be placed on the gilts buffer?*

Issues in detail : Incentives

- In the last price review considerable progress was made to align Scottish Water's incentives with benefits to customers and the environment.
- Ministers agreed that "customers should not pay twice"
- Scottish Water and the Scottish Executive recently agreed that bonuses are paid for only out of the proceeds of outperformance.
- *Can these present incentives be strengthened?*

Issues in detail : Incentives

- Ofwat have strengthened the incentives for the English and Welsh companies by using rolling incentive mechanisms.

- Rolling incentives tend to require complicated rules and calculations.

Worked example of Ofwat's rolling incentives

	AMP 2	AMP 3					AMP 4				
Financial year	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Initial regulatory assumption	275	270	265	265	260	255					
+/-Idoks assumption	0	0	0	0	0	0					
+/- logging up/down	0	0	0	0	0	0					
- less shortfalls	0	0	0	0	0	0					
Revised regulatory expectations	**275**	**270**	**265**	**265**	**260**	**255**					
Actual expenditure	265	255	250	240	238	??					
Less atypical and exceptional costs	0	0	0	0	0	0					
Less any cross subsidy adjustment	0	0	0	0	0	0					
Adjusted actual expenditure	**265**	**255**	**250**	**240**	**238**	**0**					
Outperformance	**NA**	15	15	25	22						
Outperformance (setting negatives to zero)	NA	15	15	25	22						
Outperformance constrained at 2003 level	NA	15	15	22	22						
Incremental outperformance in 2000-01		15	15	15	15	15					
Incremental outperformance in 2001-02			0	0	0	0	0				
Incremental outperformance in 2002-03				7	7	7	7	7			
Incremental outperformance in 2003-04					0	0	0	0	0		
Incremental outperformance in 2004-05											
Final incentive allowance							**7**	**7**	**0**	**0**	**0**

- *Is a simpler approach possible?*

Issues in detail : Public Private Partnerships

- PPPs were used on the late 1990s to finance major improvements in environmental compliance without recourse to public expenditure.
- Evidence suggests that they provided good value at the time, relative to the three former authorities.
- Growing evidence suggests that they are not such good relative value today, because Scottish Water has reduced costs.
- *Should PPPs be subject to an efficiency target at the next price review?*

Any other issues?