Workshop

Stakeholder workshop 5:Financing Scottish Water

Strategic Review of Charges 2010-14: Methodology

Dundee, 26 July 2007

water industry commission FOR SCOTLAND

Methodology consultation

- The methodology consultation was published in 4 volumes during May, June and July.
- We held 4 workshops on the consultation prior to its publication. We are holding this workshop, and a further 3, to help to explain the importance of the issues we are consulting on.

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

The closing date for the consultation is **19 October 2007**

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

Volume 1: Financing Scottish Water

Volume 1 of the methodology explores how Scottish Water is financed, and how it can be incentivised to continue to improve its performance.

This is important for 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.

Progress made at the 2006-10 price review

The 2006-10 review introduced a number of governance initiatives to encourage performance improvements and protect customers. These initiatives included:

- A hard budgetary constraint
- Interim determinations and logging up/down
- A gilts buffer
- Aligned managerial and organisational incentives
- Output Monitoring Group

The 2010-14 review will build on these initiatives.

Issues for the 2010-14 price review

Volume 1 seeks views on the following issues:

1. 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?

2. 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 levels of service?

3. Given that we have a 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?

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

Issue 1: Level of operating risks

Water and sewerage companies face operational risks such as:

- drought;
- public health issues;
- pollution;
- asset/process failure;
- accidents;
- health and safety issues; and
- regulatory change.

Issue 1: Level of operating risks – points for discussion

- Are the risks faced by Scottish Water any different to those faced by the water and sewerage companies in England and Wales?
- If so, what are those different risks and how material are they?
- If they are material, how should we take account of these risks?
  - If within management control then the Scottish Executive should carry the burden.
  - If outwith management control then customers should carry the burden.

Issue 2: Comparisons with England and Wales

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.

We use currently information from England and Wales in the following areas:

- operating costs
- capital expenditure
- customer service (Overall Performance Assessment)
- financial ratios and other indicators (as a measure of financial ‘good health’)

Issue 2: Comparisons with England and Wales – points for discussion

- Is it reasonable to compare Scottish Water with the English and Welsh companies?
- Are there differences that we should take into account?
- Are there other methods we could use to put Scottish Water's performance into context, and understand the scope for future improvements?

Issue 3: Protecting customers from risks

At the 2006-10 review, we took steps to protect customers from risks. These included:

- Setting a **hard budgetary constraint** – Ministers confirmed that customers should not pay twice for the same output.

- The establishment of a **gilts buffer** - an 'insurance policy' for customers. Index-linked gilt edge securities provide the finance to cover unexpected shocks, helping to limit customers' exposure to price increases.

Issue 3: Protecting customers from risks – points for discussion

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

- Should a size limit be placed on the gilts buffer? If so, how should we think about the appropriate size?

Issue 4:Use of the RCV and rolling incentives

- The “building blocks” (or RCV based) approach to price setting is commonly 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.

Issue 4: Use of the RCV and rolling incentives

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

Issue 4: Use of the RCV and rolling incentives – points for discussion

- Is it appropriate to continue our use of the RCV?
- Does our use of the RCV improve the transparency associated with the price setting process?

Issue 4: Use of the RCV and rolling incentives

- Ofwat have strengthened the incentives for the English and Welsh companies by using rolling incentive mechanisms.
- But Ofwat's rolling incentives tend to require complicated rules and calculations.

Issue 4: Use of the RCV and rolling incentives – points for discussion

- Should we seek to further strengthen the incentive on Scottish Water (and its management) to improve performance?

- Should we adopt an adjusted approach to rolling incentives? For instance, linking incentives to additions in the gilts buffer?

And finally: 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? Or are they inherited contractual arrangements beyond Scottish Water's control?