CONSULTATION

Strategic Review of Charges 2010–14: Methodology

Volume 1: Financing & governance of Scottish Water

Overview

This document explains our proposed methodology in relation to the financing and governance of Scottish Water at the 2010-14 price review, and seeks stakeholders' views.

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water industry commission FOR SCOTLAND

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How to respond to this consultation

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Please submit your response no later than **Friday 19 October 2007**.
We will publish all responses to this consultation unless respondents request otherwise.
Printed copies of this consultation are available from the address above. Electronic versions are available on our website at www.watercommission.co.uk.

BACKGROUND

Background

Context

Every four years, we set limits on the prices that Scottish Water can charge customers for water and sewerage services. The next price review covers the period 1 April 2010 to 31 March 2014.

We issued a consultation document in December 2006, which set out our overall approach to the forthcoming review. We explained that we intended to carry out a further major consultation during 2007, which would cover the methodology we should use in coming to our decisions about price limits.

The December 2006 document explained that the methodology consultation would need to consider a number of components, and that these would be grouped into four volumes, as follows.

Methodology volume	Date volume is published
Volume 1: Financing and governance of Scottish Water	10 May 2007
Volume 2: Customer revenue, levels of service and the new competition framework	31 May 2007
Volume 3: Operating costs	28 June 2007
Volume 4: Capital expenditure	26 July 2007

This document is the first of the four methodology consultation documents.

Associated documents

- 'Our approach to the 2010-14 price review: A consultation', Water Industry Commission for Scotland, December 2006.
- 'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

More detailed information about our proposed methodology in relation to Scottish Water's financing and governance is available on our website: www.watercommission.co.uk

Introduction

INTRODUCTION

In this volume, we outline our current thinking and seek stakeholders' views on the following questions.

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?

In 2001-02, the Scottish water industry incurred much higher costs and delivered a poorer service to customers than any water and sewerage company in England and Wales. It was to meet this efficiency challenge that the three former regional authorities were merged to create Scottish Water in April 2002.

The Water Industry Commissioner advised Ministers in 2001 about the charges that the then proposed Scottish Water should be allowed to levy on its customers in 2002-06. These charges included an allowance for the upfront costs of restructuring the industry and improving its efficiency. The Commissioner's principal focus was to make sure that there was a significant improvement in efficiency.

The Strategic Review of Charges 2006-10 sought to build on the significant progress that Scottish Water made after 2002. The Commission allowed Scottish Water additional resources to address leakage, to improve its understanding of its assets and to improve the level of service it provided to customers. In doing so, the Commission took account of the challenge that Scottish Water still faced.

The Strategic Review of Charges 2010-14 builds on the first two reviews. This will ensure that Scottish Water delivers ministerial objectives at the lowest reasonable overall cost. Achieving this will require regulation that makes no allowance for the governance or organisational structure of the industry. We will therefore expect that the owner, the banker and the management operate in as effective a way as the benchmark companies in England and Wales. By 2014, the Commission expects that Scottish Water will be in a position to match or better the performance of some of the companies south of the border. We propose to set prices that will require Scottish Water to improve its performance further and operate efficiently.

GOVERNANCE INITIATIVES

This document first examines the governance improvements that were introduced at the last Strategic Review of Charges. We discuss the level of operational risks that is incurred by Scottish Water. Our initial view is that the risks faced by Scottish Water and the water and sewerage companies in England and Wales are broadly similar. The Scottish Executive (in its role as banker and owner) will have to manage governance and financing risks but these are wholly within its own control. Given the current institutional arrangements, we outline our current view on the further governance improvements we consider necessary. We conclude with an outline of our overall proposed approach to financing at the 2010-14 review. We welcome the views of stakeholders on our proposed approach.

Governance initiatives at the 2006-10 review

Hard budgetary constraint

In our 2006-10 final determination, we set price limits that required Scottish Water to build on its recent efficiency improvements. Scottish Ministers had, in their principles of charging, invited the Commission to set limits on Scottish Water's borrowing that would be consistent with a gradual improvement in the business's financial sustainability. Ministers also confirmed that customers should not pay twice for the same outputs.

The resulting hard budgetary constraint means that, if Scottish Water were to spend the financial resources it has been allowed, but not achieve the required outputs, it would fall to Scottish Ministers alone to meet the costs of remedying this. As such the Scottish Executive runs much the same risks as the shareholders of a private company. We therefore propose that, because the operational risks that need to be managed are broadly comparable, the allowed for cost of capital should be similarly comparable.

Interim determinations and logging up/down

The Commission also recognised that neither management nor owner can be expected to absorb all risks. Where events, such as a new quality obligation, are outside the control of the owner/management, we are ready to change price limits within the four-year period or to recognise formally that such events will be fully dealt with at the next review. This readiness to respond to changes in the operating environment that are outside management control is important to maintaining financial discipline.

We agreed with Scottish Ministers that a £50 million credit line would be held in reserve to cover the costs of any events outside management control that were not large enough to qualify for an interim determination. This dedicated public expenditure can only be accessed with the agreement of both the Commission and Ministers. This has allowed us to fix borrowing and avoid having to reassess prices at every variance from the assumptions underpinning our final determination.

The 'gilts buffer'

The Commission agreed with Scottish Ministers that provision should be made for a buffer against risks and uncertainties. This reduces the likelihood that customers will face major increases in the levels of prices that they face because of unforeseen adverse shocks. The buffer is invested in index-linked, gilt-edged securities, in which excess cash arising from outperformance on capital or operating costs (against the allowances made in the Strategic Review of Charges 2006-10) can be held.

Aligning incentives

The Commission was pleased that Ministers recognised the importance of aligning managerial and organisational incentives. Ministers recognised that bonuses should be linked to the outputs financed in the final determination and paid only if Scottish Water outperformed its targets.

The final determination established a direct link between rewards for employees and benefits to customers and the environment.

Rolling incentives

The Commission also stated that it intended to introduce rolling incentives, similar to those that the Office of Water Services (Ofwat) introduced in its 1999 price review. Rolling incentives allow the benefit of any outperformance that an organisation achieves to be retained for four years. The benefit is then passed to customers at the next Strategic Review of Charges.

The Output Monitoring Group

The Commission also secured the agreement of Scottish Ministers to establish and chair an Output Monitoring Group. This brings together stakeholders, on a quarterly basis, to monitor progress in delivering the ministerial objectives. We regard this as an important step forward as it focuses attention on the delivery of the benefits of the investment programme. This is clearly where the interests of customers lie. Measuring the amount of investment committed may contribute to ensuring that customers receive value for money, but the principal focus must be on what has been delivered. The creation of this group, focusing on the delivery of investment, significantly increases transparency and accountability.

PROPOSED APPROACH: 2010–14

Proposed approach at the 2010-14 review

Scottish Ministers have responsibility for both the ownership of the water industry in Scotland and for developing environmental, public health and social policy. The Water Services etc. (Scotland) Act 2005 clarified the responsibilities of the owner, the regulator and the regulated company. It resulted in a more transparent governance framework for the Scottish water industry.

Our statutory remit requires us to set prices at a level consistent with the delivery of ministerial objectives for the lowest reasonable overall cost. In our view, this requires us to assume that the governance arrangements are similarly robust (even if materially different) to those that exist south of the border. However, we believe that more should be done within the current governance and regulatory framework to build on the progress made at the 2006-10 Strategic Review of Charges. Further progress will help ensure that Scottish Water is able to deliver ministerial objectives at the lowest reasonable overall cost.

We believe that these further initiatives should be considered in three distinct categories.

Responsibilities of ownership

We consider that the Scottish water industry faces broadly the same operational risks as the companies south of the border. It is therefore important that the governance arrangements in Scotland are appropriate and that neither customers nor taxpayers are exposed unnecessarily to financial risks.

In our view the interests of customers would be best served if there was pro-active management of ownership risks. Scottish Ministers have recently begun to consider their role as owner, as distinct from their role as policy maker. Ministers see no direct financial benefit from their ownership of the industry and have tended not to manage the risks of ownership in a pro-active way. We consider that if there is neither measurement nor recognition of the effective management of risks then it is less likely that these risks will be managed effectively.

In 2001, the value of the Scottish water industry was at least £500 million less than its outstanding debt. It was therefore a major liability for Scottish Ministers[1]. The significant improvement in Scottish Water's efficiency now means that its regulatory capital value is some £2 billion greater than its outstanding debt. Scottish Water has been transformed into an important asset. However, we explained above that Scottish Ministers do not receive any return on this asset. Indeed, Ministers actually have an ongoing annual financial commitment of around £200 million because any new borrowing scores against Scottish public expenditure. The Commission will have to take account of whether the Scottish Executive continues to forego a dividend.

The ownership risks arise because it would be wrong, and contrary to Ministers' declared policy, to ask customers to pay twice for any promised benefits. If there is a shortfall in the delivery of the outcomes required by the regulatory contract, it is the owner who should meet the costs of remedying that shortfall.

[1] And potentially also for customers, since Ministers had not then agreed that they would be liable for any shortfall in the performance of the industry against its regulatory contract.

More recently, Scottish Ministers have begun to manage some of these risks. For example, they recently said that Scottish Water's Board should focus on improving the performance of its core business.

The Water Services etc. (Scotland) Act 2005 however required Scottish Water to establish a separate retail entity to compete on a level playing field with other new entrants. Some of the new entrants may benefit from economies of scale and scope that are not immediately available to Scottish Water's retail entity. While the new framework has reduced the likelihood of challenge under the Competition Act, it has introduced new operational (and consequently ownership) risks for the owner. In this new competitive framework, a 100%-owned subsidiary would face quite a challenge to reduce its costs in line with what can only be a declining market share.

There are three broad choices:

- to seek to manage these risks;
- to encourage Scottish Water to take a minority stake in a retail joint venture; or
- to allow Scottish Water's retail entity to compete in the wider utility services retail markets.

Only the second two options would seem to offer a realistic prospect of maintaining a significant presence in the new retail services market. The final option would require the Scottish Executive to make risk capital available. Any returns or losses on capital provided by the Scottish Executive should not affect the level of prices paid by customers of the water industry – although it would impact on the level of public expenditure that the Scottish Executive has to make available to the industry. We do not believe that normal profits earned from wholesale and household retail water and sewerage services should be invested in Scottish Water Business Stream. Such an approach would require the customer to be exposed – in our view unnecessarily – to operational risks.

Mitigating the risks of ownership

It is clearly in customers' interests that the owner seeks to manage ownership risks appropriately. The Commission proposes to set a cost of capital that reflects these risks.

Experience in England and Wales shows that there will need to be consistent pressure from the owner if Scottish Water is to match the performance of the companies south of the border. Since the Commission has a statutory duty to set charges at a level consistent with the lowest reasonable overall cost of delivering the ministerial objectives (and customers are only to pay once), there will be a direct budgetary impact for the Scottish Executive if they are not as effective as other owners in managing risk.

We believe that customers could benefit if Ministers more clearly defined both their own responsibilities and those of Scottish Water's Board. For example, Ministers could delegate some risks to the Board. This would improve the organisational incentives created by the price settlement and could minimise the risk of management underperformance. It is important to avoid the situation where the Board can reasonably claim that limited operational discretion caused them to fail. Although Ministers would have to meet the costs of any shortfall in performance, the resulting delays in delivering the required level of service would certainly not be in the interests of customers.

We have explained why it is in the interests of customers that an owner holds the Board strictly to account for its performance against the regulatory contract. In a Scottish context this has important implications for the extent and nature of the delegated authority that the owner gives to the Board of Scottish Water. Because the Commission sets prices, the Board is constrained to offer an affordable pay and reward structure. The Board of Scottish Water needs to attract, retain and reward the staff that can deliver the regulatory contract. The accountability of the Board is less clear while Ministers still have to approve the terms and conditions for Scottish Water's staff. The owner could reduce the risks that it faces by seeking to delegate the management of pay to the Board.

Responsibilities of a lender

Customers will benefit when Scottish Water is required to operate within a hard budgetary constraint. In our view there may be merit in considering how the disciplines of commercial lending could be brought to bear on Scottish Water. Commercial bankers impose disciplines through their requirements for reporting and investment appraisals. They may also require reassurance on the expected out-turn before allowing access to further credit. In contrast, the current arrangements do not impose similar disciplines on Scottish Water. The Scottish Executive should consider how similar pressures could be applied to Scottish Water. In the absence of such pressures, it may be difficult to match the performance of the companies south of the border. The result would be that ultimately the owner of Scottish Water would have to meet the costs of any shortfall in the level of efficiency achieved by the companies south of the border. We understand that allowing commercial borrowing within the current framework of public expenditure controls may be problematic. We also recognise that the interest rate on public sector loans is lower than that on commercial debt. However, it is in the customer interest that Scottish Ministers address this issue, otherwise the risks they face will increase.

Monitoring performance

The Output Monitoring Group ensures that there is effective scrutiny of the delivery of the ministerial objectives. This improved monitoring will reassure customers that they are being provided with the service for which they have paid. It will also allow Ministers to understand how Scottish Water is likely to perform against the agreed regulatory contract and so reduces the risks they face. For example, it reduces the likelihood of an unexpected demand on public expenditure and makes outperformance of the price settlement more likely. It is also important to bear in mind that if Scottish Water fails to meet its targets, there will be less money available for other public services such as health or education.

The Shareholder Executive provides Ministers with independent, objective advice about their management of the valuable asset that is the Scottish water industry.

Our proposed approach in detail

Scottish Water is a statutory corporation. As such, it does not have a licence but derives its powers from duties and obligations required by Acts of Parliament. In the Strategic Review of Charges 2006-10 we set an initial regulatory capital value (RCV) for Scottish Water. We set the RCV such that Scottish Water was financially sustainable. We used the same financial ratios that Ofwat had applied in its 2004 price determination for the companies in England and Wales to measure the financial strength of Scottish Water.

In a private company the difference between the total return on the RCV and the net interest costs belongs to the owner of the company. This can either be reinvested or returned to the owner by way of a dividend. In a wholly debt financed company, the choice is between reinvestment, improving financial strength or perhaps returning a dividend to customers. In the case of Scottish Water, this whole difference is reinvested. The unleveraged portion of the RCV is therefore rather like equity owned by the customer. The return on this quasi equity is used to insulate the price paid by customers from the impact of adverse operational shocks.

Setting prices

We have a duty to ensure that Scottish Water has sufficient finance to enable it to deliver Ministers' objectives at the lowest reasonable overall cost. Our allowance for costs should take account of the risks that need to be managed by the owner and/or management of Scottish Water. As we noted above, we consider that the operational risks that the owner of the Scottish water industry must manage are broadly similar to those that exist south of the border. As such, we believe that it is appropriate to set a comparable cost of capital to that allowed for in England and Wales. In coming to this conclusion we have noted that Ministers have undertaken that customers will not pay twice for the required level of service. This guarantee replicates the protection provided to customers by the regulatory framework south of the border.

A standard approach to price setting uses 'building blocks', with the regulator making allowances for operating costs; depreciation (both capital maintenance and the amortisation of enhancement capital expenditure); tax; changes in working capital; and the cost of capital. The decision on the allowance for the cost of capital is often one of the most debated aspects of a price review. We plan to work with Ofwat and other regulators to ensure that we adopt a robust approach to determining the appropriate cost of capital. In particular we plan to consult with the Office of Rail Regulation on its approach to the assessment and remuneration of operational risks.

We consider that it is also important to identify market trends that are emerging and to understand any potential implications for the industry in Scotland. Recently, the increasing leverage of the companies south of the border (partly planned capital investment, partly capital restructuring) has led to a greater role for the credit rating agencies. Debt now plays a larger role in the financing of regulated utilities than was previously considered prudent.

In order to ensure that customers are not exposed to unnecessary risks, we must take careful account of the market's views of the risks faced by the water and sewerage industry. The rating agencies determine the credit-worthiness of different sectors and companies within sectors. The cost of debt for companies that maintain investment grade status is lower. In the case of regulated utilities, the agencies have indicated that compliance with a recommended suite of financial ratios is likely to ensure that investment grade status will be maintained. It has become common for regulators to adjust the level of prices so that the regulated company complies with the financial ratios that the credit rating agencies recommend.

If the Scottish Executive continues to make debt finance available at lower rates (while accepting responsibility for a failure of Scottish Water to achieve the required outputs), we propose that the difference between the commercial cost of debt and the public sector cost of debt should be allocated to the 'gilts buffer' at the end of each financial year.

Setting the cost of capital

Financial models typically calculate the allowed return by multiplying the real weighted average cost of capital by the RCV. The weighted average cost of capital requires decisions about:

- the appropriate level of gearing (ie how much of the RCV should be financed by debt);
- the cost of debt; and
- the cost of equity (that proportion of the RCV not financed by debt).

Gearing

The decision on an appropriate capital structure has recently become more difficult as the market has revealed itself to be quite comfortable with highly geared utilities. However, some companies (most notably Yorkshire Water) have not followed this trend and have maintained a relatively low rate of gearing. It has therefore become more difficult for a regulator to decide on an appropriate level of gearing. A regulator could theoretically set individual allowances for the cost of capital for each company that it regulates. The tax benefits that accrue to debt financing would however make this very complicated. It is also likely that in so doing, the regulator could end up forcing companies to adopt a particular capital structure.

PROPOSED APPROACH: IN DETAIL

Cost of debt

The cost of debt is the most straightforward element in calculating the cost of capital. There is now much greater transparency in the cost of debt for different companies. There is, however, an issue about whether to use current prices or long run prices.

A cost of debt using current prices can either allow for embedded debt, or allow interim determination-type adjustments based on changes in the observed real cost of debt. We consider that the allowance for embedded debt is a more transparent approach.

The use of long run prices (where the normal real cost of debt for water utilities can be estimated) is problematic. Companies tend to pay out surplus cash in dividends (during times when the real interest rate is lower than the long run average) and assert that the allowance for the cost of capital is insufficient when the real interest rate is higher than its long run average. In a Scottish context (where dividends are not currently paid), there would be either a lessening of the budget constraints that apply to Scottish Water or a shortfall in the required level of financing.

Cost of the unlevered portion of the RCV (equity)

The whole RCV must be remunerated at a level that allows the company to access finance and compensates the owner appropriately for the risks that it is required to manage. In this regard there are no essential differences between various ownership arrangements (although there may be specific differences in the opportunity costs of accessed capital). We propose to set a cost of the unlevered portion of the RCV that is consistent with allowing the company to access finance and compensates the owner appropriately for the risks that it is required to manage. The cost of financing this unlevered portion of the RCV (equity) is, by some distance, the most problematic element in calculating the weighted average cost of capital. There are three broad approaches:

- the capital asset pricing model (CAPM);
- the dividend growth model (DGM); and
- the use of comparators.

The CAPM requires the assessment of an equity Beta. It may be difficult to determine the beta with confidence and even a small error could be quite material in the allowance for the cost of equity. We propose to consider whether we can pursue this traditional approach.

The DGM may be difficult to use. In the case of a regulated utility, a forward looking DGM would be circular (as dividends depend on the cost of capital and the cost of capital depends on the potential for dividend growth). Considering the DGM on a historical basis removes this circularity; however, it is likely to be difficult to assess the real growth in dividends over the years since privatisation. This is because the capital structure of the water industry in England and Wales has changed significantly.

The use of comparators relies on the quality and detail of the information provided by transactions. At the current time we consider that this is most likely to be useful as a check rather than as a primary method of calculating the cost of equity.

As noted above, if the regulator has to adjust prices to comply with externally determined financial ratios, this would imply that the building blocks approach to setting prices has suggested price caps that are inconsistent with the market's view of the financeability of the water industry. This could reflect a difference in view on the current cost of capital (the CAPM calculates an average cost) or in the allowance for depreciation.

A potential alternative approach

We are considering an alternative approach. This would be to accept that the credit rating agencies contribute substantially to the market's view on the appropriate cost of capital – particularly when companies require continuing access to the debt markets for substantial sums.

We could potentially set prices that allow compliance with a suite of financial ratios, and allow for an appropriate cost of capital consistent with these ratios (plus the costs of any appropriate embedded debt allowance). This approach has the disadvantage that it is novel and untested. However, it may be more transparent and, if properly explained, is likely to be less contentious than the normal estimates of the weighted average cost of capital. We will ask leading experts in the field for their views before deciding how to set the cost of capital. Their advice will be published.

Rolling forward the RCV

In the Strategic Review of Charges 2006-10, we set an initial RCV for Scottish Water of around £4 billion for 2005-06, rising to around £5.4 billion by 2009-10. This RCV will underpin the Strategic Review of Charges 2010-14. This is important to ensure transparency, consistency and predictability.

We will adjust the RCV for the Strategic Review of Charges 2010-14 to take account of differences between:

- our assumptions for 2006-10; and
- the delivery of investment over the 2006-10 regulatory control period.

We will use logging up/down to adjust the RCV for differences in assumptions such as the efficient expenditure on capital enhancement and the level of output delivery. This process is similar to the approach adopted in England and Wales.

Each year, the RCV changes in value in order to recognise net new capital investment. This is known as rolling forward the RCV. We propose to use the same method for the 2010-14 review as we used for the 2006-10 review, which was itself based on Ofwat's method. Once again, we would welcome the views of stakeholders on our proposed approach.

Approach to depreciation

The RCV approach to price setting distinguishes between expenditure on annual maintenance and the long-run accounting charge that is included in the accounts.

In the Strategic Review of Charges 2006-10, we allowed for a high level of depreciation and infrastructure renewals charge. In practice, this did not affect the charges that customers paid as the level of revenue was determined by financial ratios.

We intend to scrutinise this area in more detail. Scottish Water is revaluing its assets and this may have an impact on its depreciation policy.

Financial modelling

In our view, the financial model worked well at the last price review and we do not consider it necessary to develop an entirely new model. However, the introduction of the framework for competition will require some changes to be made. We also plan to make the model more easy to use. We would particularly welcome the views of any stakeholders who made use of the financial model for the 2006-10 Strategic Review of Charges.

We plan to seek external advice on 'best practice' in modelling given the functionality that we require. The final version of the model structure and logic will be produced once consultation responses have been considered.

An external auditor will review the model before the end of 2007. We plan to have the model audited (with the input information) approximately one month before the draft determination is published.

We will keep Scottish Water informed about changes to the model, and offer its staff training sessions. However, we propose only to provide feedback on financial aspects of Scottish Water's business plans if it uses the price review model. In our view this avoids a risk that we misinterpret Scottish Water's intentions.

Gilts buffer

The proceeds of any outperformance by Scottish Water should normally be allocated to the gilts buffer at the end of the financial year. As such, Scottish Water should borrow in line with the profile established in the final determination, unless it invests at a materially faster or slower rate.

It will normally be straightforward to assess the extent to which Scottish Water has succeeded in bettering the assumptions in the price review with regard to operating or financing costs. It may be prudent to delay the assessment of capital expenditure efficiency until the end of the regulatory control period.

As we noted earlier, the primary role of the gilts buffer is to act as a shock absorber such that customers' charges do not vary materially as a result of unforeseen events. In essence it acts as an insurance policy. We therefore propose to assess the appropriate level of cover that customers should pay for and fix a target level for the gilts buffer in the Strategic Review of Charges. We will consider a number of factors including the potential cost of a major incident (such as the drought that Yorkshire Water experienced in 1995 or the leakage problems at Thames Water) and the financial reserve that the banks required when Welsh Water was refinanced.

The buffer could only be accessed with the prior agreement of both the Commission and Scottish Ministers. The Commission would only propose to agree if the costs incurred were outside the control of management. If a determined management could have avoided these costs, we believe that it should fall to the Scottish Executive to meet these costs.

Once the gilts buffer reaches a critical size, Scottish Water could adopt a similar approach to that pioneered by Welsh Water and return a 'dividend' to customers. We would be interested to hear the views of stakeholders on these proposals.

Rolling incentives

There are three main approaches to rolling incentives that we could consider:

- adopting Ofwat's approach to rolling incentives;
- adopting an adjusted approach to rolling incentives; or
- taking the decision not to include rolling incentives.

We are currently of the view that replicating Ofwat's approach in Scotland may significantly reduce the transparency of our approach to setting prices. This is a function of the complexity of the Ofwat approach to rolling incentives. However, we do see benefit in providing an incentive to Scottish Water (and its management) in order to maintain the pressure to improve efficiency. Our current preferred approach would be to link rolling incentives to additions to the gilts buffer. In doing so we would also expect bonuses for the staff of Scottish Water to be linked partly to growth in the buffer and partly to other indicators of performance such as those measured by the Overall Performance Assessment.

We would welcome the views of stakeholders on this change to the plans that we outlined in the Strategic Review of Charges 2006-10.

Public Private Partnerships (PPPs)

Scottish Water inherited nine wastewater treatment PPP contracts. These contracts were let for between 25 and 30 years. The contracts delivered around £700 million[2] of capital expenditure. More than 10% of Scottish Water's annual revenue is accounted for by these PPP contracts.

[2] Post efficiency, current prices.

The contracts represented value for money, given the efficiency of the three former water authorities. However, given Scottish Water's improvement in performance and the fall in real interest rates, there is now some question about the relative efficiency of these contracts.

In our 2005 final determination, we allowed for Scottish Water's estimated PPP costs in full. We did however raise concerns about the continued value for money of PPP schemes. We decided not to set efficiency targets for the PPP contracts but said that we would return to this issue if there was no evidence that Scottish Water was sharing in the benefits of the lower financing costs enjoyed by the PPP contractors.

HM Treasury Guidance says that the public sector partner should receive 30% of the benefit of any refinancing of legacy PPP contracts. We intend 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 (and Scottish Water is not able to provide evidence that it has tried), we may seek to impose an efficiency target on the PPP expenditure.

We consider that this approach is in the best interests of customers but realise that this may not be popular with the PPP contractors.

NEXT STEPS

Next steps

The final date for responses to this consultation is Friday 19 October 2007. We encourage all interested parties to get in touch with us to express their views about our proposed approach.

We will publish a response to the consultation findings on Thursday 20 December 2007. Please use this opportunity to take part in the debate.

Questions for consultation

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?

10.05.07

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