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Ms Katherine Russell
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16 October 2007

19 OCT 2007

Dear Madam

On behalf of Aberdeen Environmental Services Ltd (AES), I would like to thank you for the opportunity to make representations on Volume 1 of your consultation document "Strategic Review of Charges 2010-14 : Methodology".

The detailed response from AES is attached.

If there are any aspects of our response which you would care to discuss further, please contact me.

Yours faithfully

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Director

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Response from Aberdeen Environmental Services Ltd to the Water Industry Commission's Consultation Paper on the Methodology for the 2010-2014 Price Review

Introduction

1. Aberdeen Environmental Services Ltd (AES) provides waste water treatment services to Scottish Water at four waste water treatment plants in the Aberdeen, Peterhead and Fraserburgh areas through an existing PPP/PFI. AES has recently entered into a Variation to the original concession agreement to receive additional flows from the Stonehaven area into one of its existing waste water treatment plants in Aberdeen. AES comprises Kelda Water Services Ltd, a subsidiary of Kelda Group plc, Balfour Beatty Capital Projects Ltd, a subsidiary of Balfour Beatty plc and Earthtech Engineering Ltd, part of the Tyco group of companies.

2. AES is pleased to be provided with this opportunity to respond to the Water Industry Commission's consultation document on the methodology to be used in the review of Scottish Water's charges 2010-2014.

3. In Volume 1, Methodology Paper 9, of the Consultation document, the WIC identifies two specific issues concerning the financing of the existing PPP contracts, namely

   - Refinancing of the contracts, and
   - Renegotiation of the contracts to reflect reduced levels of revenue costs being borne by the contractors

4. In particular, it is intended to establish whether Scottish Water has sought to improve value for money from the contracts through negotiating the existing contracts using either or both of these approaches.

5. We have concerns with both of the approaches that the WIC proposes that Scottish Water should implement. Whilst it is clearly important for Scottish Water to assure itself that it receives good value from the contracts, it must equally be recognised by all parties that these contracts were fully negotiated at the time and entered into in good faith. The AES contract has a duration of 30 years with a significant risk transfer to the contractor and it is not appropriate within that structure to concentrate on short term issues to the detriment of the arrangements in the long term.

Refinancing of the Contracts

6. Two principal reasons are identified why the WIC believe it may be possible to reduce the cost of capital in the contract. However, both arguments appear flawed in the specific context of the AES contract.

7. Firstly, we agree with the WIC that the real cost of borrowing has declined since signing the contract in 2000. However, this has minimal impact on the particular structure of the AES contract. When the financing was originally structured, the core funding rates were fixed using derivatives (swaps) for the term of the contract in order to provide all parties with certainty in the cost of finance. These swaps can be broken but the cost of breakage, which would mainly be payable to the existing lenders to compensate them for their future, lower returns, would offset the entire benefit of the lower current market rates for the remainder of the contract. Consequently, there would be no net benefit to the project after paying for the breakage costs. It is recognised that there has been a small decrease in the market in lending margins but this is negligible in the context of the contract payments and the margins we have remain competitive.

8. Secondly, the area where there has been large publicised refinancing gains in some availability-based accommodation projects has been in raising extra debt finance against future risk buffers that the market now considers higher than required. (In practice, these refinancing gains have resulted from a single, one-off distribution to shareholders financed from additional funds having been injected into the project by the lenders). However, demand-based waste water projects are very different from availability-based accommodation PPP projects, many of which are now owned by financial investors who have little interest in projects after they have stripped out the refinancing gains and risk buffers. In waste water projects, significant risks will continue to be managed by the contractor over the life of the project, some of which are not within the control of the contractor. For example, AES faces a significant drop in revenue imminently because certain large industrial dischargers in the catchments of some of our facilities have either ceased trading or have made alternative arrangements for disposing of their waste water. It is important for all to understand that any crystallising of these risks does not give rise to any entitlement under the contract to an increase in the tariff. We therefore believe that our risk buffers are still required to the extent that they have not already been used.

9. AES is already properly incentivised to refinance the project where there is an economic case. Within the existing contract, there is an existing provision for Scottish Water to share in these refinancing gains should there be a case. In addition, in the AES contract, Scottish Water can also benefit in the event that there are additional returns earned from other sources, such as increased revenues or lower costs, in excess of those anticipated by shareholders. These two factors together will ensure that Scottish Water and its customers continue to share in any future benefits.

Reduced Revenue Costs

10. We do not really understand what reduced revenue costs are being referred to here. Scottish Water is fully aware of the changes required to our facilities and operating practices that were required to treat what turned out to be much more influent than any party expected. The additional costs and additional investment in excess of the extra revenue generated from the additional influent have been borne by the project. Furthermore, it is well known that insurance and energy costs have spiralled upwards since the original contract was signed and, despite

the fact that it is now common for authorities to share in these particular risks, the contractor on our project has had to bear all of these cost overruns. In particular, energy costs which represent more than 20% of the revenue costs of the plants have increased by more than 75% in the last 5 years thus reducing significantly the overall profitability from the project. On the other hand, the annual tariff which increases with RPI, has increased by about 16% over the same period. Although these increased costs have been mitigated to some extent through more efficient energy recovery processes, the contractor has not sought to either recover these unexpected revenue costs or the additional investment in treatment improvements from Scottish Water.

11. Furthermore, whilst Scottish Water, and indeed other English and Welsh water companies, have an opportunity to review their cost base as part of their respective periodic price determinations, neither AES nor its contractor has that opportunity and must continue to bear the impact of these and any further cost increases over the remaining life of the contract.

12. In summary, we are long term investors and contractors in the AES project and accordingly consider our risks and potential liabilities over the entire contract period. We anticipate that we may have to make changes to our facilities over time as circumstances change, and that there will be unexpected events that will impose additional costs on the project. I am confident the WIC will agree that the AES board would not be acting in the interests of the company or Scottish Water if it were to endanger the long term ability of the company to cope with such unexpected events. At this stage, there is little if any benefit in refinancing the project. If there were to be an economic case, the contract already provides for Scottish Water to benefit from those savings. So far as revenue costs are concerned, the only experience we have of major changes to the cost base are increases, rather than reductions, in costs from exogenous sources.

13. The Board of AES believes that the PPP contracts have and will continue to deliver good value for Scottish Water and its customers. You can be assured that AES will continue to manage those risks which would otherwise add to the pressure on the bills of Scottish Water's customers.

14. We trust that the WIC continues to recognise the benefits which PPP has already delivered for Scottish Water's customers and will continue to encourage PPP's as part of the delivery of water services in Scotland.