water industry commission FOR SCOTLAND

Staff Paper 2

Governance and incentives

This staff paper has been produced by our office to assist stakeholders in responding to the Draft Determination. The material reflected in this staff paper has informed the preparation of the Commission's proposed conclusions. However, this staff paper does not form part of the Draft Determination. Accordingly, this staff paper should not be relied upon as expanding upon or replacing anything contained in the Draft Determination.

2.1 Introduction

In recent years, Scottish Water's customers have benefited from rapid improvements in customer service at a time when prices have generally been stable. This performance improvement has occurred, at least in part, because of the governance and incentive regime in which Scottish Water operates.

As Scottish Water is a public sector company, the Scottish Government plays crucial roles in its governance – including making available the public expenditure that Scottish Water requires to borrow in order to finance its investment programme. The Draft Determination is published at a time when there is likely to be increasing pressure on public expenditure. These uncertainties have been taken into account by the Commission in setting out further steps to develop the governance and incentives framework within which Scottish Water operates.

This paper sets out:

- a summary of the framework that was outlined in the Strategic Review of Charges 2006-10;
- changes to the framework that occurred following the review; and
- the framework the Commission expects to operate in 2010-14.

2.2 The framework outlined in the Strategic Review of Charges 2006-10

Introduction

The Commission sets charge caps that it believes allow Scottish Water to finance the delivery of the Scottish Government's objectives at the lowest reasonable overall cost. In accepting the 2006-10 determination, Scottish Water's management agreed to deliver all of the outputs within the financing allowed for in the determination during the regulatory control period. This forms the 'regulatory contract'.

In the Strategic Review of Charges 2006-10, there were six principal governance initiatives. These are designed to put continuous pressure on Scottish Water to improve its performance, thereby benefiting customers. They are:

- a hard budget constraint;
- a temporary loan facility (£50 million until 2010) to cover unexpected costs such as emergencies or changes in legal obligations, but not the costs of management failure;
- a growing savings account (or 'gilts buffer') to replace this facility, financed by outperformance of the regulatory contract;
- transfer of savings to customers after four years, keeping bills down;
- bonuses to Scottish Water's management that can only be paid when the company has outperformed its regulatory contract;
- formal scrutiny every three months of Scottish Water's delivery of the investment benefits required by Scottish Ministers.

Hard budget constraint

In the Strategic Review of Charges 2006-10 the Commission set out clearly that Scottish Water had to operate within the resources allowed for in the determination. It believed that a monopoly business (like Scottish Water) would face weak incentives to improve if it were to have recourse to further financing.

Importantly, the Scottish Government confirmed that water customers would not pay twice for any output financed by the Strategic Review of Charges. This meant that, should Scottish Water spend the financial resources available to it without delivering an output, the Scottish Government would be liable to meet the costs of remedying this.

Temporary loan facility

The Commission recognised that, during the four years covered by the review, there may be events that either increased or decreased Scottish Water's costs. In the case of a cost increase, there may also have been events, such as a new water quality obligation, where Scottish Water's management could not have been expected to manage the risk within the generality of price limits.

The Commission therefore committed, if such an event were material in impact, to reviewing charge caps within the four-year period, through an interim determination process. Where such an event was not material in impact, the Commission stated that it would formally recognise the event at the next Strategic Review.

In order to maintain the limits on borrowing, the Commission and the Scottish Government agreed a £50 million credit line to allow for events outside management control that may not be large enough to qualify for an interim determination. This £50 million was dedicated public expenditure, which was only to be accessed with the prior agreement of both the Commission and the Scottish Government.

Growing savings account

The Commission agreed with the Scottish Government that a fund should be created that acted as a buffer against risks and uncertainties. The buffer was to be invested in index-linked, gilt-edged securities, in which excess cash arising from outperformance on capital or operating costs could be held.

This gilts buffer was intended to maintain the pressure on Scottish Water to improve its performance, by ensuring that good performance in one period could not be used to pay for poor performance in another period.

Transfer of savings to customers after four years

Customers benefit if Scottish Water improves its efficiency. However, if the benefit of any efficiency saving is immediately passed to customers, Scottish Water may be less inclined to make the savings. The Commission therefore suggested a regime whereby Scottish Water would be allowed to retain the benefits of any outperformance for a regulatory control period, before it was to be returned to customers through lower prices.

Managerial incentives

The Scottish Government recognised the importance of aligning managerial incentives with the organisational incentives established through regulation. It recognised that bonuses should be linked to the outputs financed in the Final Determination and only be paid if Scottish Water outperformed its targets.

The Strategic Review of Charges therefore allowed a direct link to be established between the rewards for managers and workers and the benefits to customers and the environment. The size of the financial reserve built up could be used to gauge financial performance that was better than expectations and Scottish Water's customer service could be measured objectively using the overall performance assessment (OPA).

Formal scrutiny every three months

The Strategic Review of Charges 2006-10 signposted the creation of an Outputs Monitoring Group (OMG). Chaired by the Scottish Government, the OMG scrutinises

Scottish Water's progress in delivering its investment objectives. This significantly increased the transparency of decision-making.

2.3 Developments in Scottish Water's governance

Since the Commission published the Strategic Review of Charges 2006-10 there have been some noteworthy changes to the governance and incentive framework.

In that review, the forecast borrowing profile varied according to the forecasts of Scottish Water's investment needs. The Commission expected Scottish Water to vary its borrowing profile according to its actual investment plans, making use of its end-of-year flexibility without exceeding the overall maximum level of borrowing that was assumed when setting prices.

As outlined in the Commission's 2007-08 Costs and Performance Report, in July 2008 Ministers published governance directions that could reduce Scottish Water's flexibility to manage its finances. The directions specify that Scottish Water may not withdraw funds from the financial reserve without the prior approval of Scottish Ministers. They further specify that Scottish Water must make withdrawals from the financial reserve if Scottish Ministers direct it to do so.

As well as introducing governance directions, the Scottish Government made two further changes to the financing of Scottish Water:

- it removed Scottish Water's 'end-year' flexibility, where Scottish Water could carry forward unused public borrowing between years within a regulatory control period; and

- it instructed Scottish Water to use all of the financial resources available to it in the 2008-09 and 2009-10 financial years.

Whilst these changes may have assisted the Scottish Government in managing its finances, the Commission considers that it would not be in water customers' interests if these were to be continued. There are four main issues with the incentives that these changes introduce.

First, there could be an incentive for Scottish Water to spend money inefficiently. This could happen if Scottish Water felt that financing might not be available after the end of a financial year so therefore rushes to spend money before the end of the financial year without achieving appropriate value for money.

Second, Scottish Water is required to deliver all outputs by the end of a review period. The Commission would be concerned if the changes introduced by the Government resulted in less financial flexibility for Scottish Water and as a result outputs were not delivered. It is important that Scottish Water cannot use lack of availability of borrowing as an excuse for tardy output delivery.

Third, the gilts buffer arrangement is a strong incentive for Scottish Water's senior management to make efficiency savings. However, this incentive relies on the reserve being there in order to finance any unexpected cost shocks that may hit the industry. There can be little incentive on Scottish Water's management if, in making efficiency savings, this money is immediately removed.

Fourth, it is important that Scottish Water can manage its business flexibly over a full regulatory control period. There can be no guarantee of the extent to which a regulatory contract has been outperformed until the regulatory control period has ended. This is because Scottish Water has the full period to deliver the Scottish Government's objectives through its capital expenditure programme. The Commission would not regard costs that are reduced by more than expected as outperformance if some objectives had been missed as a consequence. Complete assessments can only be made after the full regulatory control period has ended.

2.4 Governance initiatives at this Strategic Review

Introduction

The Commission believes that two changes to the governance and incentive framework are required in order to ensure that it works for the benefit of customers. These are:

- a fixed and flat borrowing profile; and
- clarity concerning the roles of the gilts buffer and gilts reserve.

Fixed and flat borrowing profile

In modelling Scottish Water's charge caps for 2010-14, assumptions were made about the level of debt that Scottish Water will require. Unlike at the previous Strategic Review, there would not be any material unused borrowing relative to what the Government was prepared to make available[1].

It has been assumed that Scottish Water will draw down this borrowing in equal annual amounts over the regulatory control period, irrespective of its annual investment needs. This would make clear the actual level of borrowing that Scottish Water would require in any year of the regulatory control period; the Scottish Government would be able to plan with certainty the level of finance that it would need to make available.

At this review, the level of financing to which Scottish Water may require access at the start of the next regulatory control period is also being made transparent. This is forecast to be in the order of £170-£200 million – an amount that may increase by up

[1] In the assumptions about a four-year review, the Commission has used the full £150 million per year that the Scottish Government has indicated it is prepared to make available. In the proposals for a five-year review, the Commission has assumed £140 million of the £150 million in each of the five years.

to 5% each year in nominal terms if the Scottish Government wants to see the level of investment maintained in real terms.

The Commission recognises that the Scottish Government may face increasing pressures on its available budget. If the Scottish Government is unable to make the required level of borrowing available in this regulatory control period or the larger sums that will be needed in the future, it could consider using the Scottish Futures Trust as a vehicle for providing finance to Scottish Water or, if possible, allowing Scottish Water to borrow commercially along the lines agreed for Network Rail. In this regard, recent HM Treasury budgeting guidance[2] that suggests PPPs should be accounted for under UKGAAP[3] (ie off balance sheet) and recent press commentary that PPP contracts may remain off balance sheet even under the new International Financial Reporting standards are noted.

In proposing charges, a real cost of debt of 3.5% has been allowed for. Any difference between this allowed for cost and the actual cost faced by Scottish Water should be credited to the Scottish Water reserve account. The allowed for cost of debt has meant that no special allowance for Scottish Water's embedded debt is necessary. This allowed for cost of debt should improve the chance that, in the event that the Scottish Government is unable to make the necessary level of public expenditure available, the Scottish Futures Trust would be able to make the necessary debt finance available on a commercial basis. There would be no adverse impact on customers as a result.

Clarity concerning the roles of the gilts buffer and gilts reserve

The gilts buffer has two main purposes:

- it acts as a transparent incentive on Scottish Water's management to deliver all of the outputs financed by the Determination at a lower cost; and

- in the event of a cost increase that was beyond the influence of a determined management, it can mitigate the impact of the increase on customers' bills and/or public finances.

The Commission determines charge caps that cover a fixed period, during which time annual costs may be higher or lower than assumed when charges are set. Further, it is only once Scottish Water has completed its capital programme that the Drinking Water Quality Regulator and the Scottish Environment Protection Agency can confirm that outputs have been delivered. There is therefore a need for a complimentary mechanism to the gilts buffer that takes account of annual variances in financing that may be outperformance, but are subject to regulatory confirmation. The Commission agreed with Scottish Water that this should take the form of a gilts reserve.

Figure 2.1 outlines how the gilts reserve may be expected to operate.

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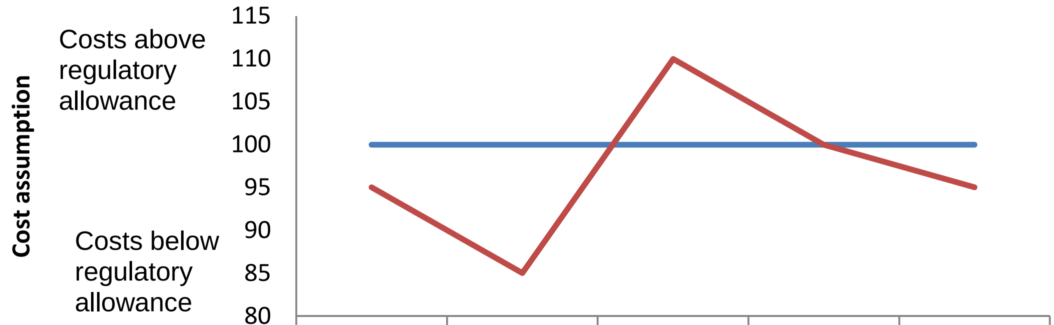
[2] http://www.hm-treasury.gov.uk/d/consolidated_budgeting_guidance200910.pdf

[3] Generally accepted accounting principles.

Figure 2.1: Example of gilts reserve



	Year 1	Year 2	Year 3	Year 4	Year 5
Regulatory cost assumption	100	100	100	100	100
Actual cost	95	85	110	100	95
Annual transfer to gilts reserve	-5	-15	10	0	-5
Cumulative total gilts reserve	5	20	10	10	15

The example in Figure 2.1 shows Years 1 and 2 of a regulatory control period as a period where Scottish Water has incurred lower costs than were assumed when setting prices. However, by the third year in this example, Scottish Water's costs have risen beyond those that were allowed for in setting prices and these only fall below the assumed level again in Year 5. After Year 5, the Commission assesses whether Scottish Water has delivered its outputs and only if it believes Scottish Water has can money be transferred from the gilts reserve to the gilts buffer and confirmed as outperformance. However, if further work were required to complete output delivery, this would be netted off the gilts reserve and this would reduce the amount transferred to the gilts buffer.

There could be two issues with assuming that the value of the gilts reserve in any one year automatically represented the value of outpeformance. First, it may be that Scottish Water is unable to demonstrate that it has delivered its outputs and the resources in the gilts reserve are required (at least in part) to be used to remedy this. Second, it may be that there are higher costs in a later year that offset performance and reduce the value of funds in the reserve. In the example in Figure 2.1, if it had been assumed after Year 2 that £20 million was the value of outperformance, this would have left Scottish Water short of finance in the remaining years and overstated the eventual value of the buffer.

A further function of the gilts reserve in the forthcoming regulatory control period will be to hold temporarily any differences that result from Scottish Water borrowing a fixed amount each year and the profile of how Scottish Water spends money to finance its investment programme. This increases the likelihood that the gilts reserve would overstate the extent of likely outperformance during the regulatory control period.

Clarifying the respective roles of the gilts buffer and gilts reserve should help avoid any incorrect inferences that may be made about the level of outperformance that Scottish Water has achieved.

2.5 Summary

There are a number of governance and incentive arrangements that increase the pressure on Scottish Water to improve its performance, thereby benefiting customers and the environment in the longer term. For these arrangements to be effective, the Scottish Government must ensure that access to borrowing to finance the investment programme is available. To do otherwise would result in prices to customers that were higher than they needed to be. If the Scottish Government cannot do this, it could consider using the Scottish Futures Trust as a vehicle for providing finance to Scottish Water or allowing Scottish Water to borrow commercially (along the lines agreed for Network Rail).