

The Scottish Government's Consultation on the Scottish Futures Trust: the response of the Water Industry Commission for Scotland

Introduction

The Water Industry Commission for Scotland has a statutory duty to ensure that customers pay charges for water and sewerage services that are consistent with the Scottish Government's principles of charging and the delivery of its objectives for "the lowest reasonable overall cost". The Commission considers that the creation of an effective Scottish Futures Trust (SFT) could benefit customers of the water industry in Scotland.

The Scottish Government's consultation on the SFT raises two distinct issues. It discusses the future financing of infrastructure projects in Scotland. But it also addresses issues relating to the procurement, delivery and management of infrastructure projects. The consultation envisions a new organisation that would have to be appropriately resourced and would seem to require highly experienced and qualified experts in both financing and procurement.

In our role of ensuring that the customers of Scottish Water pay no more than necessary, we consider carefully the financing of Scottish Water. We also review how Scottish Water delivers its capital programme, the level of operating costs that it incurs and the value for money of its PPP contracts. This experience may be useful to the design of the SFT. Our response draws on this experience and our review of the value for money of its PPP contracts. It is clear that Scottish Water's performance in delivering its capital expenditure programme has improved as it has strengthened its finance, procurement and contract management teams.

Financing

The Commission allows for an appropriate cost of capital in setting price caps for Scottish Water. In so doing we have sought input from leading investment banks and other experts. We then tailor the market cost of capital for the operations of a water and sewerage company to reflect the governance and ownership arrangements of the industry in Scotland, so reducing the prices that customers would otherwise have paid.

There are three factors, which, taken together, reduce the allowed for cost of capital. These are that:

- Scottish Water is subject to economic regulation. Its regulator has a duty to ensure that it is allowed to raise sufficient revenue to finance the efficient delivery of its obligations.
- It has a steady and predictable income stream
- The governance framework of the industry is clear in the respective responsibilities and accountabilities of the Scottish Government, the regulators (both economic and quality) and Scottish Water.

These factors combine to reduce the risk profile of the industry and ensure that it can be more easily assessed. The Commission considers (and external experts have confirmed) that the governance arrangements could be further strengthened if Scottish Water operated under a licence. This would further clarify the accountability and responsibility of Scottish Water and provide an improved means of enforcing the regulatory contract. It could reduce further the risks that the Scottish Government is underwriting and, in turn, customers' bills. In our view, the governance arrangements of the SFT and its contractors are likely to be critical.

The creation of a SFT could benefit both the customers of the water industry in Scotland and the Scottish Government. If Scottish Water was subject to the scrutiny of lenders, it is likely that its investment appraisals would be more effective, further improving its efficiency. This may allow Scottish Water to have a higher level of gearing. This would have longer run tax advantages and result in lower bills for customers.

Where there are valuable economies of scale (eg the banking and legal fees), it would be sensible for the SFT to aggregate smaller infrastructure projects when it raises finance. However, larger organisations with robust governance arrangements and a reliable income stream (such as Scottish Water) might not benefit if the SFT were to borrow to finance its full portfolio of projects in aggregate. The providers of finance normally offer keener rates when their covenants can relate directly to the delivery of specific assets (eg project finance). We believe that the design of the SFT should take account of this issue and ensure that the creation of the SFT can bring benefits to large investors in infrastructure as well as those who invest on a smaller scale.

Procurement and delivery of infrastructure

Scottish Water is financed to invest over £500 million a year in its assets. It is the largest single customer of the civil engineering market in Scotland. Its efficiency in delivering this investment has a material impact on the bills that customers pay. As such, continuous improvement in procurement and contract management are important to delivering value for money to customers.

We have worked with Scottish Water, the Scottish Government and the Quality regulators to improve the monitoring of this investment. This has led to the creation of the Output Monitoring Group, chaired by the Scottish Government. We have also encouraged both Scottish Water and the Quality Regulators to conduct detailed studies of the required improvements before committing valuable resources. In the current regulatory control period, this has led to marked reductions in the scope of work required to address both sewerage and water resource problems. This agreement also contributed significantly to our ability to keep increases in customers' bills below the rate of inflation.

This success contrasts with the Scottish industry's experience of public private partnerships (PPP). Scottish Water inherited 9 PPP contracts from its predecessor bodies. These contracts provide about half of the wastewater treatment in Scotland (measured by volume) and about 80% of the treatment

of sludge. However, we have had concerns about the value for money of these contracts for some time¹. Our concerns relate to price; the lack of flexibility; the enforcement of compliance with both environmental and customer expectations and the transfer of risks.

Our analysis of the value for money of these contracts suggests that Scottish Water could now deliver a better level of service for a lower cost than the PPP contracts. We have also concluded that the return being paid to the PPP contractors is substantially in excess of the cost of equity that Ofwat allows the privatised water and sewerage companies south of the border². We consider that the introduction of the SFT could ensure that we do not need to resort to such expensive methods of service delivery in the future.

These PPP contracts were entered into for periods of between 25 and 30 years. There is little scope in the contracts to renegotiate the required outcomes (either for customers or for the environment). The SFT could learn from this experience and further benefit Scotland if it incorporated some form of scrutiny (similar to that of the Commission in regulating Scottish Water) into its proposed governance arrangements. This could ensure that the SFT meets the needs and expectations of citizens both now and in the future at the lowest reasonable cost.

Moreover, the existing PPP contracts do not have good mechanisms for enforcing compliance. Although Scottish Water has no powers to intervene in the operation (or maintenance or enhancement) of these important assets, it is still legally responsible for any failure of the service provider. The spillage of sewage into the Forth Estuary last spring is a good example. The SFT may want to consider how to avoid similar issues.

It will be well positioned to avoid such issues if it has expertise in financing, procurement, project definition and understanding business risks. It will also be important to ensure that the SFT is appropriately resourced. In this regard, it could learn from Scottish Water's experience that it is important to have the high quality internal resources available initially to challenge and then to manage its contractors.

Conclusion

We would be happy to discuss with the Scottish Government our experience in financing and monitoring the delivery of the largest infrastructure investment programme in Scotland with the Scottish Government.

¹ See for example 'The Strategic Review of Charges 2006-10: The draft determination', Volume 5, Chapter 8, June 2005.

² 'The Strategic Review of Charges 2006-10: The draft determination', Volume 5, Chapter 10, June 2005.