

Scottish Water Future Funding Options

Executive Summary

This paper considers options to increase the efficiency of funding for Scottish Water (SW), whilst retaining public ownership in line with SFT's 2009/14 Corporate Plan. It has been prepared following consultation with stakeholders in the industry, to give a view on whether there could be credible and deliverable options. The paper does not seek to promote any single option and does not consider any differential benefits to the wider landscape of infrastructure investment in Scotland. It focuses entirely on structural and funding options for SW itself.

The three structural options considered are:

- 1) Ownership 'for the people' by Government – the structural status quo where the Scottish Government (SG) is the shareholder and holds the board to account for the company's performance;
- 2) Ownership 'by the people' in a mutual structure where each customer has a direct share of ownership;
- 3) Ownership 'for the people' by a Public Benefit Corporation¹ where members represent the people and hold the board to account and where every customer has the economic benefit of ownership through receiving any distributed surpluses as a dividend.

The conclusion of the study is that options 1 and 3 are both viable and have reasonable precedent whereas option 2, a mutual of this scale requiring member consent and potentially member liabilities is judged to be the most risky and potentially not viable.

Under Option 1 "Status Quo" options to improve funding efficiency and reduce the call on SG capital budget requirements within the existing corporate and ownership structure would require either: a reduction in investment; or an increase in water charges both of which are equally unpalatable. Indeed the need to plan long term investment, such as upgrading Glasgow's sewer network, will compete for SG capital funding against other priorities such as schools and roads. SW currently accounts for 5% of the SG capital budget but, even at current levels of water investment, this will grow to c10% as capital budgets shrink. The potential for the government to gain borrowing powers may allow sustainable investment under option 1 but, under likely HM Treasury (HMT) rules or external control frameworks, it is unlikely that a borrowing power in itself will remove the need to make unpalatable decisions on investment priorities and/or water charges.

Under Option 3 "Public Benefit Corporation" the conclusion of the study is that this structure could form a financially and operationally viable alternative to the status quo of SG

¹ Public Benefit Corporations, sometimes also known as public interest companies using the corporate form of a Company Limited by Guarantee, are already widely used in housing with many housing associations being structured in this way.

ownership, whilst maintaining the Company's outputs and customer charges at current levels. Under the Public Benefit Corporation structure the public as customers would take the benefits of ownership in the form of dividends or rebates on charges, and the Company's borrowings would be refinanced from Government to banks and the capital markets in the form of debt and bonds. In this form, whilst retaining ownership for the public, the Company would be non-Government classified for national accounting purposes, eliminating its call on Government budgets. There would be no need for intrusive oversight by financiers, or contracting out of operations given the current stability of the Company and a well structured transition. There are both benefits and disadvantages of this possible alternative structure:

The potential benefits of a public benefit corporation structure compared to the status quo of Government ownership would be:

- **Ongoing capital budgets:** removal of ongoing borrowing from SG capital budgets (approximately £140m per annum) allowing this to be invested in other priorities.
- **Receipt:** immediate cash receipt to Government of around £2.75bn as existing debt is repaid, (£1.2bn raised post devolution and £1.5bn pre-devolution), with around £0.25bn to 0.75bn additional receipt if gearing were to be increased, subject to detailed financial modelling.
- **Comparative borrowing cost:** the cost of finance available from private sources in regulated water companies is close to that of Government borrowing and would be below that achieved in other infrastructure sectors such as PPP and NPD.
- **Customer dividend:** There could be a further future benefit to customers in the form of a dividend, or rebate on bills consequent on good corporate performance.
- **Long Term Planning:** The Company would benefit from the stability of being able to plan infrastructure investment, and investment in more entrepreneurial activities, over longer periods and based on planned programme and business efficiency rather than being constrained by SG Capital DEL budgets

The potential disadvantages of a public benefit corporation as compared to the status quo of SG ownership would be:

- **Control:** SG would relinquish control of the Company that it ultimately has currently as its owner, however the regulator would continue to act to protect customers.
- **Financial Market Volatility:** the public benefit corporation would be exposed over time to the private sector funding markets which are more volatile than the status quo of being a part of national debt borrowing.
- **Transaction cost:** The one-off cost of completing a transaction into public benefit corporation would be substantial, running into millions of pounds.

Should SG consider the option of a public benefit corporation worthy of further consideration, the key risks are considered to be:

- **Parliamentary Process:** The need for legislation and the associated parliamentary process;
- **Management distraction:** Such a significant corporate change would be demanding and therefore potentially distracting for senior management.
- **Financial market pricing:** The cost of debt, level of potential gearing and ultimately in the worst case financial viability of a refinancing would be dependent on the financial markets at the time of the transaction;
- **Timing:** the time taken to refinance in this way could be less than 12 months and could move as quickly as the parliamentary process would allow. Civil Service and other stakeholder momentum would have to be driven and maintained.
- **Governance:** There is a risk that Government, interest groups or the parliamentary process introduces requirements or constraints over the structure or the nature of Members or Directors which could fundamentally affect the operations and stability of the entity over the long term;
- **Receipt Distribution:** Discussion with HMT would be required as to the apportionment of the capital receipt between Scottish and UK Governments.

So, there are possible disadvantages as well as the potential benefits of avoiding a £140m per annum call on SG Capital DEL budgets and gaining a £2.75 to £3.5bn receipt associated with adopting a public benefit corporation structure for SW. However, such a structure would be deliverable without impacting operations or water charges, which would remain a matter for the regulator. In moving to a new structure to seek funding efficiency, there would be risks along a path necessarily including primary legislation.

Any decision to undertake further work on a potential alternative structure is one for SG, as owners of SW and as instigators of the legislative change that would be required. This paper is intended as a dispassionate analysis of potential options to be used to inform thinking on this important issue. Should any questions arise from this report, or further work require to be undertaken, SFT would be happy to engage further on the subject as and when required.

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**Scottish Water
Future Funding Options**

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1. Introduction

This paper considers briefly future financing and structuring options for Scottish Water (SW). It fulfils the SFT 09/14 Corporate Plan commitment to:

“In collaboration with other interested parties, work-up, and assess options to increase the efficiency of funding for Scottish Water, whilst retaining public ownership, that could be considered by Scottish Ministers”

The paper has been developed by SFT following consultation with stakeholders and interested parties including Scottish Government (SG), SW management, the Water Industry Commission for Scotland (WICS), Welsh Water management, and various financiers and advisors. The expertise and input of these organisations is much appreciated and has been essential in shaping this paper, however the paper represents exclusively the independent views of SFT and has not been reviewed, commented on or approved in any form by any other party.

Any change in structure or funding of SW is a matter for SG as it would require primary legislation. The prioritisation of what criteria are considered important in determining the most efficient arrangements are also therefore a matter for SG. From SFT’s independent perspective of seeking value for money for infrastructure investment in Scotland, an important consideration is the efficient use of Capital budgets across all sectors of infrastructure investment. It is from this perspective that this paper serves to highlight some options, and characteristics of those options to assist in informing thinking on this important issue.

2. Options assessed

SFT’s assessment of options has been limited to those retaining public ownership. This is not an artificially imposed constraint but is born of a belief that whilst privatisation would deliver the maximum receipt to Government in the short term; it would not deliver any incremental long-term funding or operational efficiency in the regulated environment and would give up future benefits for the people of Scotland.

Within the ambit of public ownership lies a range of structural options that we consider in more detail in this paper. These can be summarised as:

- 1) Ownership “for the people” by Government – the structural status quo;
- 2) Ownership “by the people” in a mutual structure where each customer has a direct share of ownership;
- 3) Ownership “for the people” in a public benefit corporation – See Annex 1 for key features.

Only the first of these is classified as “public sector” for the purposes of the national accounts, and would therefore necessarily create a call on SG’s capital budget for financing. The others are classified as “private sector” for national accounting whilst retaining beneficial ownership for the people of Scotland.

Within the status quo option, we consider:

- 1a) funding through a combination of user charging and borrowing from SG capital budgets (the financing status quo);
- 1b) funding wholly from user charging through reducing investment to match user charging receipts;
- 1c) funding wholly from user charging through increasing user charges to meet identified investment priorities.

The potential to increase the Company's efficiency to remove the call on Government borrowing has been disregarded as it has not been deemed possible by the Regulator in the current pricing settlement.

A further possibility is that in future SG could gain its own borrowing powers. Under this potential future arrangement, Capital investment in the Country's infrastructure (including SW in SG ownership) would not be constrained by DEL budgets but could be managed, and extended through borrowing if deemed necessary by SG. The structural status quo would nonetheless retain SW's call on Government capital funds, with its debt adding to the national debt. As such, its future borrowing requirements would be subject to management along with other priorities within the fiscal, or external control frameworks of any SG borrowing powers.

As a framework for SG borrowing powers does not currently exist, it is not considered further as an option in this paper. However, given the undoubted constraints on public borrowing under any framework and calls from other sectors for capital investment, the structural alternatives considered would remain valid alternatives for consideration.

3. Assessment Framework

The purpose of the assessment is to determine whether more efficient funding options can be found. A range of features were therefore developed within which this could be evaluated against the status quo. The features encompass both financial considerations and governance, operational and deliverability points that affect the viability of options considered. Those considered particularly significant are:

- a) **Call on SG Capital Budget:** SW currently has an annual borrowing requirement to finance capital investment. As a publicly classified Company (controlled by Government) this borrowing creates a call on SG capital budget wherever the funds are borrowed from. To minimise interest costs, SW borrows from SG though it is not constrained to do so. The call on SG capital budget will average £140m per year over the next 5-year regulatory period. Eliminating this call on budget to free it for other essential capital investment in a time of unprecedented capital scarcity is a key driver for considering other options. It should be noted that this overriding objective may at least be partially removed if the SG was to gain borrowing powers, as recommended by the Calman Commission, but as the rules attached to the mooted borrowing powers are unknown this future potential is not explored further at this stage.
- b) **Stakeholder acceptability:** SW is publicly owned and primary legislation would be required for any restructuring. It is an absolute requirement that any future structure can

gain public and political support. SFT has not assessed public or political opinion directly but considers the following features to be essential in generating support:

- i) **Non-profit Distributing** – It is assessed not to be publicly acceptable for private investors to take profit from the provision of water (both supply and disposal) to household customers in Scotland. Any “surpluses” should be reinvested or returned to customers as a public benefit;
 - ii) **Stakeholder Involvement** – It is considered important to have some form of stakeholder involvement in the governance structure, with interests of SW users represented;
 - iii) **Charge stability** – the current regulatory settlement brings charge stability, and no charge increases up to 2015. An important feature of any changed funding structure is its ability to adhere to the price review for the current regulatory period (up to 2015) and ideally locking in no real price increases for the following period, within the context of ongoing in-perpetuity strong economic regulation;
 - iv) **Workforce protection** – A key stakeholder group is the workforce of SW and its representatives. There would inevitably be concerns that any change in structure or funding could lead to workforce reduction, and / or a diminution of benefits such as pension.
 - v) **Structural lock** – Any revised structure delivered through primary legislation should not be capable of further amendment without further primary legislation. It should be locked-in at the outset.
- c) **Operational Efficiency:** SW has successfully increased operational and investment efficiency over previous regulatory periods and has accepted the challenge set by the Regulator to do so again in this current period. Any change in structure should maintain, or ideally enhance the drivers of the Company, and senior management to continue to seek and deliver operational, capital and financial efficiencies in the business;
 - d) **Financeability:** A change in the funding structure of the Company must be demonstrably deliverable in current and reasonable anticipatable market conditions, and must lock in ongoing financeability of the Company’s options and investment needs;
 - e) **Ministerial control of outcomes:** An ability for elected Ministers to control the outcomes required of the Company, especially its environmental performance through targeted investment, is required in order that the significant impact of the Company’s operations on the natural environment of the Country is adequately controlled;
 - f) **Operable governance structure:** Any structural change would require a change in governance arrangements. Critical to the stability and efficiency of a new model, and particularly important to the Company itself, is an operable and sustainable model that recognises and properly embodies the roles of owner, board, financier and executive.

- g) **Financial Efficiency:** Financial and hence economic efficiency is a driver to maximise the benefit of any change, and a particular focus of the Regulator. Any proposed change would have to be deliverable within the regulatory settlement.
- h) **Capital Receipts:** In addition to eliminating a call on future SG capital budgets, a financial and structural change could deliver a capital receipt to the public purse. Such a receipt could be used for investment or to reduce national debt in a time of constrained public finances, and its maximisation is therefore a consideration.
- i) **Legislation Requirement:** SW's structure and funding is tightly defined in primary legislation. It is therefore important to consider the need for time consuming and expensive primary legislation in any options to amend the funding or structure of the Company.

4. Options Assessment

Feature	Status Quo 1(a)	Reduce investment 1(b)	Increase charges 1(c)	Mutual 2	Public Benefit Corp 3
Call on SG capital budget	Borrowing from SG capital £140m pa	No SG borrowing, reduced spend	No SG borrowing, increased charges	Private sector borrowing	Private sector borrowing
Non-profit distributing					
Stakeholder involvement					
Stable charges			Charges increase to cover total investment		
Workforce protection		Lower investment = fewer overall jobs			
Structural lock				Interest groups could instigate change	Locked in with stable membership
Operational Efficiency		Operating efficiency down with investment			
Financeability	Uncertain future capital budgets			Large scale funding of true mutual untested	Recognisable to markets and accepted
Ministers frame outcomes		Low spend so inability to meet outcomes			
Operable Governance				Diverse ownership and consent issues	Clarity from the outset and caution required
Financial Efficiency	Low gearing driven by budget availability	Further reduced gearing	Further reduced gearing	Gearing can be set to maximise efficiency	Gearing can be set to maximise efficiency
Capital Receipt	None – ongoing call on capital	None	None		
Legislation Required		Only possible at next review without change	Only possible at next review without change	Primary legislation required	Primary legislation required

Red shading indicates a significant issue, Orange, a potential issue and Green, no issue in relation to that feature for a particular option.

5. Options Discussion

The options analysis matrix shows that:

Status Quo: Maintaining the status quo is clearly a viable option. It would cause least disruption and is the only viable option that does not require primary legislative change. It retains the current governance and operating arrangements which have been shown to be capable of delivering significant ongoing operational and investment efficiencies. However, under this structure, the Company continues to call significantly on SG capital DEL budgets and its level of borrowing and hence investment is constrained by budget availability. The effects of this constraint have driven down the gearing² of the company to its current 56%, which is generally considered lower than optimal for financial efficiency of an asset-based company of this nature.

Reduced Investment: Reducing investment levels by the Company could remove its call on SG capital DEL budgets. However, its outputs particularly in environmental and sustainability performance would be severely constrained as would its ability to invest to make operational efficiency savings. Such a change would be severely disruptive to the business, would affect jobs in Scotland and would only be implementable without legislative change at the next pricing review in 2015. It is not considered viable.

Increased Charges: Increasing charges could allow the Company to finance all its investment needs from customer revenues. This again would not be possible until the next price review, would reduce financial efficiency and raise issues of intergenerational equity. Generally, the increasing of water charges in this way is not considered likely to be publicly acceptable and is therefore not viable.

Mutualisation: Mutualisation of the Company would see its ownership transferred by SG directly to its customers, with all registered customers having a share of ownership, similarly to the Cooperative Group. In funding and financing terms this would look similar to a public benefit corporation discussed further below. However, in governance terms the ownership base would be very diverse and largely disinterested. There would be significant issues of consent and opt-out in relation to customers becoming owners. A concern over deliverability would be the availability and pricing of finance on the required scale to a mutual organisation of this nature which remains largely untested. For the longer term, this governance structure could be open to manipulation by vocal interest groups such as the “carpet-bagging” interests in the mutual building society sector. Due to this untested and potentially unstable governance structure, a mutualisation is not considered optimal.

Public Benefit Corporation: Transferring the company into a Public Benefit Corporation would involve the establishment of a new top-company following a company limited by guarantee structure with a group of members representing the people of Scotland. SW would then be transferred from SG ownership into the ownership of this new Public Benefit Corporation. There is an operating and directly comparable precedent for this structure in Welsh Water. The Company would raise debt from the markets allowing Government

² Gearing is the level of debt in the Company as a % of its total value; in this case, the Regulated Asset Value (RCV) as measured by WICS.

borrowing to be repaid and potentially creating an additional receipt through increasing the gearing. The benefits of ownership (ie potential future profits) would rest with the customers, the people of Scotland, in perpetuity and could lead to distributions in the form of reduced bills. There would be no change to the operating company (Scottish Water), its Board or operating regime, however SG would no longer be owners. SG would be able to require outputs of the Company under the regulatory regime but would not have the closer level of control that it current has as owner. The structure has been proved to be financeable and is capable of delivering a stable and sustainable governance regime, though care would be needed over its initial establishment. The structure could be delivered with no increase in charges or changes to investment levels during the current regulatory period, but would require primary legislation. Given the proven financeability and operability of this option, along with its ability to remove the call on SG capital budgets and deliver a capital receipt whilst protecting ownership for the benefit of the public, it is considered to be a viable alternative to the status quo.

6. Public Benefit Corporation

A Public Benefit Corporation is also known as a Public Interest Company and would take the corporate form of a Company Limited by Guarantee (CLG), with legal ownership of that company by a group of members, and beneficial ownership resting with the people of Scotland as customers. Annex 1 gives key features of a Public Benefit Corporation and some examples of organisations structured as CLGs.

As the option of transferring SW into a public benefit corporation is considered viable by SFT, a further explanation of key features is set out below in order that a better informed view can be taken of whether the option is worthy of further exploration as compared to the status quo.

6.1. Financing

SW is currently owned by SG, with new investment partially funded from user charges, and partially through debt raised from Government. The total value of the Company (calculated formulaically by the Regulator as its Regulated Capital Value “RCV”) is approximately £5bn³, with 2.75bn (55%) being debt from Government and the remaining 2.25bn representing equity held by SG on behalf of the people of Scotland. The regulator (WICS) allows the Company an assumed cost of debt, comparable to that achieved by the privately financed Water Companies in England, and a return on equity in its price review formula. SG does not take the return on equity as “profit” out of the Company, so SW’s value increases over time more quickly than a similar corporation where shareholders take profits.

Under a public benefit corporation structure, the Government debt would be replaced by debt from the private markets through a refinancing. Benchmarking and market analysis undertaken for SFT by KPMG indicates that the cost of privately raised debt should be broadly equivalent to the cost allowed in the regulatory settlement. Therefore, charges would not have to be increased to cover any additional cost of private finance under this structure. The SG owned equity would be gifted into the public benefit corporation, where it would

³ Significant rounding of figures for simplicity of explanation

again be held on behalf of the people of Scotland. In future, assuming reasonable corporate performance and stable debt pricing, the return on equity allowed by the Regulator would translate into a rebate or “dividend” distributed to Customers. The dividend would be on a “per-customer” basis, so each connected household and business would receive the same dividend whatever their usage / billing level. It is this process that distributes the economic benefits of ownership, and hence brings ‘beneficial ownership by the people’

The debt in the public benefit corporation would be privately classified for national accounting purposes and would therefore not account against the national debt. Future increases in borrowing (currently projected to be in the order of £140m per annum) would not count against the SG’s capital DEL budgets. The process of refinancing would see the (approximately) £2.75bn of Government debt repaid through a cash receipt to Government. This repayment could either be used to repay national debt, or spent on capital investment by Government. Discussions would be required over whether the receipt would be to HM Treasury (ultimate holders of the national debt) or to Scottish Government (owners of SW on behalf of the people of Scotland). Resolving this point is out of the scope of this paper, but it is clear that approximately £1.2bn of the debt was raised through borrowing from SG capital DEL budgets post devolution, in an environment where the Barnett formula does not account for similar costs in England where the industry is privatised; and £1.5bn is pre-devolution debt.

It would potentially be possible to increase the indebtedness of the Company in any refinancing into a public benefit corporation. This increase in debt would increase the gearing of the company as its overall value would be unaffected. This would be seen by many commentators as increasing the financial efficiency of the company, through increasing the (relatively cheap) debt financing and reducing (relatively expensive) equity finance. It would also bring its gearing more closely into line with the capital structure of most comparable companies in the regulated utility sector. Through the refinancing, the effect of increasing gearing would be to create an increased cash receipt to Government at the time, leading to sustainable, but higher interest costs for the Company in the future, and lower customer distributions as the value of their equity on which a return would be due, would be lower.

There would be significant debate on what a sustainable and prudent level of gearing for the company would be as this ratio, along with the closely associated ratios of cash generated to interests payments due, affect the credit rating, and hence cost of borrowing of the Company. At current gearing levels of circa 55%, the Company would be likely to be solidly ‘A’ rated. Any gearing increase over say 65-70% would be likely to reduce that to a BBB rating, but in current markets the commensurate increase in cost of borrowing would not be great. An increase over 70-75% would be regarded as a heavily leveraged structure, with significant associated oversight and covenant requirements from lenders which would be constraining, but not un-manageable for management of the company. Leveraged structures with gearing over 80% are seen in the industry and can be operable.

Recommending a gearing level for a public benefit corporation is outside the scope of this paper, but as an example, it is considered that gearings between 60 and 70% would be sustainable within the current regulatory settlement. Increasing debt levels to these values would bring additional cash receipts to Government of £250 - £750m at the time of a refinancing without significantly affecting the future sustainability of the business. Given the

challenges facing public sector capital budgets over the coming years, such an additional receipt could be given consideration as a means of funding other investment priorities.

Debt financing of a stable company in the regulated utility sector, such as SW is a relatively cheap form of financing from private institutions as the risk profile is well understood and considered low. Importantly for considering efficiency of funding and financing across public infrastructure as a whole, the weighted average cost of capital (WACC) for SW as a public benefit corporation with a regulated asset base would be lower than for other forms of private infrastructure finance such as project finance used in PPP structures.

Annex 2 shows graphically Government, public benefit corporation and private structures and financing for comparative purposes only.

6.2. Governance

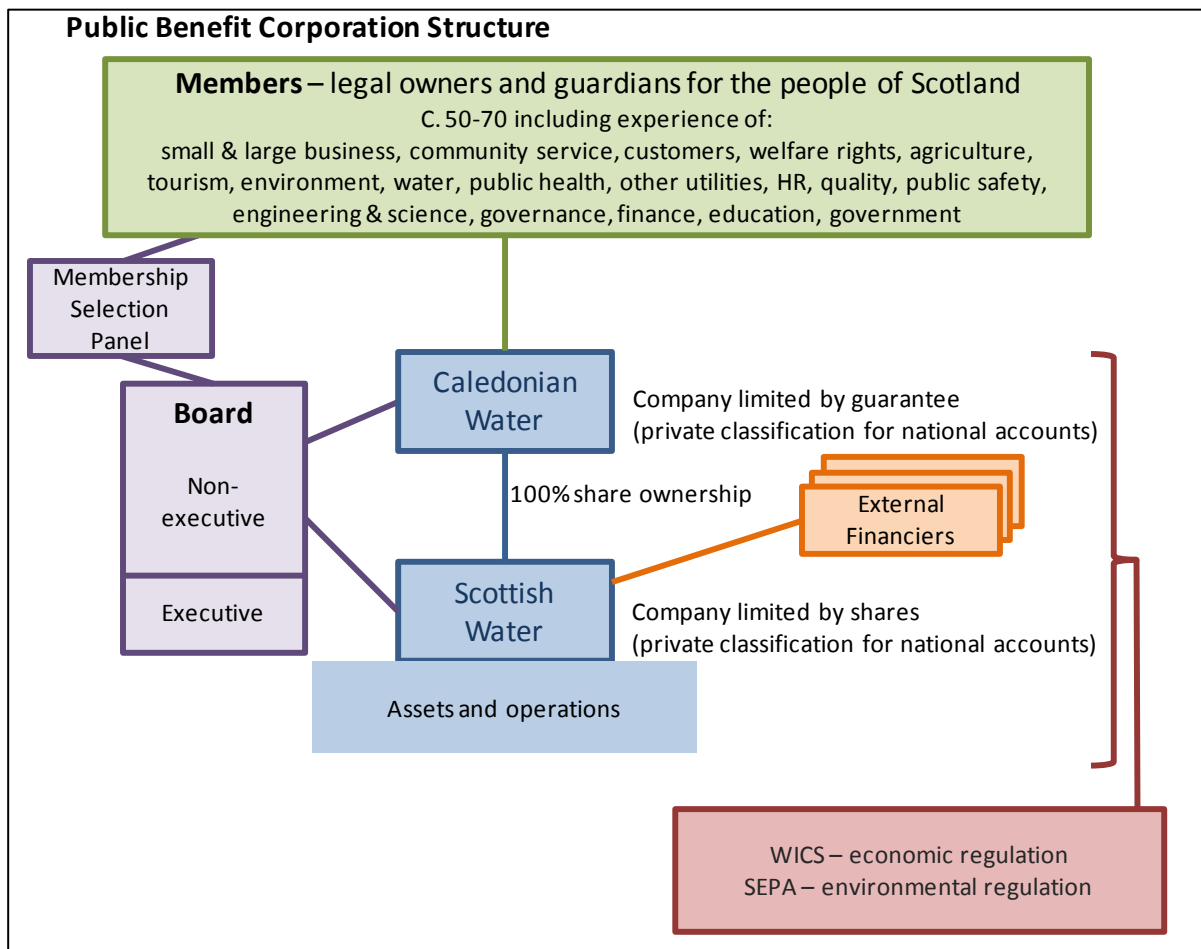
The structure and governance arrangements of the Public Benefit Corporation would be those of a Company Limited by Guarantee (CLG), similar to that of Glas Cymru (Welsh Water) or Network Rail. The structure and governance (Board) of the operating company Scottish Water would be unaffected, but would see its ownership be transferred from SG to the new top-level Public Benefit Corporation named for the purposes of this paper “Caledonian Water”. Caledonian Water would act as a holding company for Scottish Water only and would not undertake and operations. It would have Directors (Board members) performing the same role as they would in any Company, and a number of Members performing the ownership role akin to shareholders in a private company. The Directors could be common with those of Scottish Water. Indeed, the high calibre and reputation of non-executive Directors is particularly important in this structure. The role of the Members would be that of a guardian, safeguarding the structure of the Company and ensuring that the operating company, Scottish Water pursues its business in the interests of the people of Scotland who they represent. The constitution of the Company, controlled by the Members, would limit its range of activities and lock-in the structure and assets for future generations.

An important feature of the public benefit corporation governance structure is the number and selection process of the Members and an in-perpetuity replacement mechanism. This must be free from Government / political control or influence in order for the entity to be privately classified for national accounting purposes. A potential model, shown to be workable by Welsh Water is to have a body of 50-70 members, drawn from across Scotland and beyond who represent the people and bring particular relevant skills and experience, but who are not representing any specific group or interest. The members would be appointed by the Board on the recommendation of a wholly independent Membership Selection Panel against a set of published criteria. With too small, or too large a member group, or if there were members directly representing specific interests there would be a danger of governance instability and undue direct influence on the operation of the Company which would be problematic for its operational and financial stability.

The role of WICS as the economic regulator would be broadly unchanged by a restructuring into a public benefit corporation, but consideration would be required over enhancing the Regulator’s duty to ensure that the company remains financeable. The role of SEPA as the environmental regulator would again remain unchanged.

The role of Government would be to make the laws within which the Company (like any other) would have to operate and set outcome requirements which, through the regulatory settlements would have to be delivered by the Company. SG would not have operational control, or ability to veto Board decisions as it currently does in its role as owner of the Company. This structure, applicable in England and Wales, alongside the strong role of the regulators, has been shown to deliver a stable and efficient water supply and disposal industry.

The following diagram sets out a potential organisational structure:



6.3. Welsh Water Comparison

There is a directly relevant comparator for a potential Caledonian Water public benefit corporation model in the form of Glas Cymru, the similarly structured public benefit corporation holding Welsh Water. The current corporate and governance model, along with its financing structure are very similar that that which could form an alternative to SG ownership in Scotland. However, there are important differences in background as Glas Cymru was a privately instigated structure established to buy-out a distressed private sector water company post privatisation of the English and Welsh industries. This background leads to a number of key differences which mean the models are not directly comparable:

- **Legislation** – as the industry was already privatised in England and Wales, no primary legislation was required for movement from a privately owned for private profit to a public benefit corporation structure. As SW is currently Government owned, primary legislation would be required for any change;
- **Financing** – the newly established Glas Cymru had to bid for Welsh Water as it was sold from distress in competition with profit-seeking private bidders. As such, it had to raise debt as close as possible to the entire Regulated Capital Value of the company in order to be the successful bidder. This led to a close-to 100% gearing structure with significant financial covenants, oversight of management by financiers and a requirement to de-gear the business over time. The gearing is now reduced to approximately 70%. In Scotland, with the ownership gifted from SG into the public benefit corporation there is no need to gear up, with the associated level of control by financiers, to complete a sale in competition,.
- **Operations** – Due to the high debt gearing and distressed operations, it was a financier requirement to reduce risk that the operations of Welsh Water were substantially outsourced to other companies for fixed prices over the whole regulatory review period⁴. This gave cost certainty against the covenant of substantial industry suppliers and the ability for external financiers to lend at such a high gearing. As above, the financing of any transition in Scotland would be different and no contracting out, or outsourcing of operations would be required as part of a change.
- **Distributions** – Distributions to customers from Glas Cymru have been at a relatively low level to date, again due to the need to retain surpluses to pay down debt and reduce gearing following the initial establishment. No certainty of surpluses could be offered under a public benefit corporation structure in Scotland, but the need to re-capitalisation would not form the same medium-term barrier that it has in Wales.

7. Delivering a Change

Transferring SW from SG ownership into a public benefit corporation would, as discussed, require primary legislation and would be a significant, potentially disruptive and costly financial transaction. Following any decision by SG to commit to a change, and given parliamentary priority, it could take around 12 months to secure a change though this would require all stakeholders to move at speed.

Considering the consultative and parliamentary processes required is outside the scope of this paper and would be a matter for SG should it consider a restructuring option to be worthy of more detailed consideration. Agreement with HM Treasury would also be required over the cash receipt to Government. The other steps to a change would be corporate and financial:

Corporate: The establishment of the public benefit corporation (Caledonian Water in this paper) would have to be independent of Government. This could be undertaken reasonably quickly by interested private parties with interim Directors and Members should SG indicate

⁴ Operations are now being brought back into Welsh Water delivery.

that it was minded to enact legislation allowing transfer of ownership of SW to such an entity.

Financial: The private debt raised to refinance existing Government debt would be a mixture of bank lending and bond issues with different maturity profiles, and possibly including a blend of standard and index linked bonds. The process of raising this debt would be accomplished in tranches over a period of more than a year, so as not to significantly perturb the markets and affect pricing. The new entity would initially take on Government's debt and would repay Government as the new private debt was raised. Any increase in gearing would have to be completed at the time of transfer of ownership in order for Government to benefit from the receipt which could be in the form of a consideration for transfer of ownership.

8. Benefits, disadvantages and risks

The potential benefits of a change to a public benefit corporation as compared to Government ownership which could be delivered without affecting the operations of SW, or increasing charges to customers differentially from the status-quo position are:

- **Ongoing capital budgets:** removal of ongoing borrowing from SG capital budgets (approximately £140m per annum),
- **Receipt:** receipt of around £2.75bn to repay existing debt with up to around £0.75bn additional receipt if gearing was increased, subject to detailed financial modelling.
- **Comparative borrowing cost:** the cost of finance available from private sources in the public benefit corporation structure would be below that currently achieved in other infrastructure sectors such as project financed PPP and NPD arrangements, and would be relatively close to the Government's cost of borrowing;
- **Customer dividend:** There could be a further future benefit to customers in the form of a dividend, or rebate on bills in the event of good corporate performance.
- **Long Term Planning:** The Company would benefit from the stability of being able to plan infrastructure investment, and investment in more entrepreneurial activities, over longer periods and based on planned programme and business efficiency rather than being constrained by SG DEL budgets

The potential disadvantages of the public benefit corporation structure against the status quo of Government ownership are:

- **Control:** SG would relinquish the control of the Company that it ultimately has currently as its owner, and the associated perception would be lost.
- **Financial Market Volatility:** the public benefit corporation would be exposed over time to the private sector funding markets which are differentially more volatile than the status quo of being a part of national debt borrowing. However, finance in the regulated utility sector has shown relative stability to the rest of the private financial marketplace even during recent turbulent times.
- **Transaction cost:** The one-off cost of completing the legal and financial work of a transaction into public benefit corporation would be substantial, running into millions of pounds.

Should the option of a public benefit corporation be considered worthy of further consideration, the key risks are considered to be:

- **Parliamentary Process:** The need for legislation and the associated parliamentary process creates inherent risk, in particular when the commercial viability of the outcome would be dependent on the detail of the resulting legislation;
- **Management distraction:** SW has delivered significant efficiency improvements in operations and investment over recent years. Such a significant corporate change would be highly distracting for senior management.
- **Financial market pricing:** The cost of debt, level of potential gearing and ultimately in the worst case financial viability of a refinancing would be dependent on the financial markets at the time of the transaction, or during the period over which tranches of finance were raised. Good structuring and advice can mitigate this effect, but ultimately market pricing will apply.
- **Timing:** the time taken to refinance in this way could be less than 12 months and could move as quickly as the parliamentary process would allow. Civil Service and other stakeholder momentum would have to be driven and maintained.
- **Governance:** Central to the long-term success of a public benefit corporation would be its governance model established at inception. There is a risk that Government, interest groups or the parliamentary process introduces requirements or constraints over the structure or the nature of Members or Directors which could fundamentally affect the operations and stability of the entity over the long term;
- **Receipt Distribution:** Discussion with HMT would be required as to the apportionment of the capital receipt between Scottish and UK Governments;
- **Non-core activities:** the treatment of non-core activities and businesses is outside the scope of this paper to date, but careful consideration of their inclusion within any public benefit corporation model would be needed early in the planning for a transition.

9. Conclusion

Scottish Water is a reasonably well-performing business owned by SG on behalf of the people of Scotland. As such, its debts contribute to the national debt, and its ongoing borrowing requirement counts against SG DEL budgets. This paper has considered options for increasing the funding efficiency of SW whilst retaining public ownership. It concludes at a high level that there is probably only one viable alternative to the status quo in the form of a Public Benefit Corporation where SW would be owned in a company privately classified for national accounting purposes, but with public beneficial ownership, paying dividends to its customers – the people of Scotland.

The paper identifies that there are disadvantages as well as potential benefits of such a structure, and risks along a path necessarily including primary legislation to effect a change.

Any decision to undertake further work on this potential alternative structure is one for Scottish Government, as owners of SW and instigators of the legislative change that would be

required. This paper is intended as a dispassionate analysis of potential options to be used to inform thinking on this important issue.

Should any questions arise from this report, or further work require to be undertaken, SFT would be happy to engage further on the subject as and when required.

ANNEX 1 - Public Benefit Corporation Features

There are nine criteria that specify what a Public Benefit Corporation, also known as a Public Interest Company is:

1. An organisation for specific public benefit.

The organisation must be “clearly and publicly identifiable as a public benefit or public interest organisation”. Thus, the organisation must be recognised as an entity that serves the public interest, rather than shareholders’ or directors’ interests. The constitution of ‘public interest’ must be transparently linked to clear outcomes and objectives, and these outcomes embodied in the Memorandum and Articles of Association.

2. A public benefit organisation over time.

The new organisation must feature a guarantee that it cannot be transformed into another form of organisation that does not provide public benefit. This also precludes the handing over of assets to any other external body; in the case of insolvency, assets are to be taken over by another PBC.

3. A trading organisation.

As far as possible, income and resources are to be generated by trading for the delivery of services. This trading will be with individuals as customers, or potentially, with government departments procuring public services.

4. A cost-effective organisation.

Incentives must be in place so that efficiency and effectiveness is ensured.

5. An entrepreneurial organisation.

Within the public interest constraints mentioned, the organisation must be encouraged to explore possibilities for operational improvements and new revenue streams.

6. A secure not-for-profit organisation.

Profits are not to be distributed to people outside the organisation. Any surpluses must be reinvested in a way that ensures the public interest, as specified by the publicly stated objectives, or returned to customers (the public);

7. An organisation that can raise capital on the money markets

The organisation should have the capacity to raise capital from the money markets, notably from the bond markets.

8. An accountable organisation.

The organisation must construct governance structures that enrol a number of stakeholders into the decision-making of the organisation. As there will be no shareholders, accountability will be very different from other company forms.

9. An organisation independent of direct political control.

The organisation needs to be free from government operational control. The organisation will also be subject to regulation.

Examples of Companies Limited by Guarantee

The Company Limited by Guarantee corporate structure spans sectors and sizes of organisation. Examples include very significant asset owning entities as well as large and small charities and social enterprises, bound together by a non-profit distributing ethos. Examples include:

1. Glas Cymru – owner of Welsh Water
2. Nominet UK – the internet domain name registry;
3. Oxfam – also a charity;
4. Network Rail – owners and operators of the UK rail network infrastructure (not trains)
5. Many Housing Associations (Registered Social Landlords)
6. Northern Ireland Energy Holdings – owners and operators of gas pipelines and infrastructure
7. England and Wales Cricket Board;
8. The Big Issue – social enterprise
9. The Eden Project

Note:

In England the term ‘Public Benefit Corporation’ has come to be associated with NHS Foundation Trusts as the Health and Social Care (Community Health and Standards) Act 2003 established NHS Foundation Trusts as a specific new corporate form referred to as a Public Benefit Corporation. This specific narrow use of the term in England is not the same as the use in this paper, where it refers to a Company Limited by Guarantee run for public benefit.

ANNEX 2 - Impact of Alternative Structures and Financing

