

Water Industry Commission for Scotland

BORROWING BY SCOTTISH WATER: WICS APPROACH

A note by the Chairman

Overview

At the presentation of the Commission's (WICS) price determinations for Scottish Water (SW) from 2006 to 2010, questions were raised about the level of borrowing allowed for by WICS and in particular suggestions were made that it could be increased to provide lower prices to customers. I agreed, on behalf of WICS to look into this matter.

The Task of the Commission

The task of WICS under the Water Services etc. (Scotland) Act is to set price limits on the basis of "lowest reasonable cost". Its conclusions are set out and explained in The Strategic Review of Charges 2006-10: The final determination. November 30 2005.

In its final determination, WICS allowed for levels of operating and capital costs and a return on capital that would provide sufficient finance for SW to meet ministerial objectives and improve customer service.

The level of borrowing allowed for by WICS in setting price limits depends crucially on the allowances that it made for capital investment, particularly investment needed to enhance services. It also depends on the cost of interest payments and the financial ratios it believed that SW should meet. In particular it ensured that SW would be able to meet the financial ratios – determined in the financial markets – that are used by Ofwat to set prices in England & Wales (E&W). These financial issues are explained in Section 5, pp 265 to 300.

As the Finance Committee accepted, it is the responsibility of WICS to decide on "a prudent level of borrowing within the expenditure limits, not to agree to a level of borrowing consistent with the public expenditure limits", (2nd Report 2004, para 109).

Financing an arm's length body

WICS is legally obliged to set tariffs on the basis of the lowest reasonable cost of achieving ministerial objectives and providing good customer service. In doing this it treated SW as a free standing body, looking at the balance between the charges that would be paid by current and future customers as well as at the source of finance available to it.

No body, governmental, corporate or personal, is able to borrow unlimited sums at prevailing interest rates, and this approach has been applied to SW to ensure that there is no over-borrowing that could store up trouble for owners, managers and future customers.

One important aspect of utility regulation is the hard budget constraint that should face the managers of the regulated body. The absence of a hard budget constraint fatally weakens incentives to efficiency.

Within the hard budget constraint, SW faces risks on revenue, on operating and capital costs and on interest costs, which are subject to management control. As bankers and other lenders recognise, an over-borrowed enterprise is an over-stretched enterprise and might not be able to deal with such circumstances without default on its debt.

In order to protect themselves from potential default, lenders always impose ratio tests of one kind or another and prudent borrowers rarely borrow up to the hilt. WICS has adopted those used in the water sector in E&W, where prices are also capped and where water and environmental quality objectives must be met. These ratios have developed as bond markets and have become more tuned to the needs of and the associated risks of regulated utilities. Their application always involves an element of expert judgement.

Other borrowing entities may have recourse to options such as cost cutting or increasing revenues by raising prices. In the case of a utility such as SW, cost cutting that could prejudice the attainment of ministerial objectives and of good customer service could not be tolerated, and revenue is capped by price limits. The ratios therefore provide a straightforward and necessary financial discipline on management.

In a regulated utility, where events are outside management control, for example the imposition of a new obligation, regulatory action may need to be taken. This could involve more borrowing and higher tariffs. Such action would then impose a new hard constraint on the enterprise.

The risks facing SW are not identical with those facing companies in E & W. The objective (or systematic) risks facing SW may be less, because WICS is particularly close to the information concerning SW, although that information is deficient in some respects, and operates a four rather than five year price control period. But the relative inexperience of SW in managing in the new regulatory regime may involve greater subjective (or specific) risk than in E&W.

The risks facing the wider public sector are not the same as those facing an individual enterprise within it. The public sector, taken as a whole, faces a different set of risks – and it has often been argued that these risks should be averaged over the whole public sector. This would, however, be inconsistent with setting individual budgets for specific public sector activities and an important element of managerial discipline would be lost.

The importance of expert judgement

At the level of the individual enterprise, the amount of borrowing that is both wise and prudent will depend on many circumstances facing the individual enterprise; these may be internal factors related to management capability and external factors such as the nature of the market. At the level of the whole economy, total public borrowing may be constrained by factors such as the ratio of taxation to national income (GDP), or levels of public expenditure or factors such as the rate of inflation.

All these considerations and the constraints that they lead to require an element of expert judgement, in particular judgements about how best a set of different elements can be brought to bear on a decision about the right level of borrowing when bearing in mind all the relevant circumstances. This is equally relevant for economists and ministers at the macro economic level as for managers and bankers at the micro economic level of the individual enterprise.

Conclusions

- i) WICS has calculated the financial ratios in the same way as Ofwat. This is covered in the Final Determination documentation.

- ii) All borrowing decisions involve looking at the special circumstances of the case. A rule such that borrowing should always finance all net investment will inevitably neglect important considerations and would, in the vast majority of cases need to be modified significantly to fit individual circumstances.