water industry commission FOR SCOTLAND

Scottish Water's draft business plan: Financial assumptions

Scottish Water published its draft business plan on 30 October 2013. This note is one of a series that the Commission is publishing to provide an objective assessment of the plan and to facilitate discussions between the Customer Forum, Scottish Water and other relevant stakeholders.

The Commission is aware that Scottish Water and the Customer Forum have been in regular and detailed discussion over many months. In drafting these notes the Commission has been briefed by the Customer Forum on its emerging thinking having seen the draft business plan as it was being developed. As such the notes contain advice on areas that the Customer Forum has identified as being important to it.

The notes highlight the strengths of the business plan and areas where the Customer Forum may wish to focus its discussions with the company. Although each note focuses on specific areas of the plan that are material to customers, final decisions should be taken 'in the round', reflecting the overall package of price and service levels agreed between the Customer Forum and Scottish Water.

Introduction

Inflation and other economic assumptions play an important role in forecasting future revenues, charges, costs and financial strength. The impact of these economic assumptions is even greater in Scotland than in England as Scottish Water's borrowing allowance is capped in nominal terms.

This note presents the Commission's view of the financial assumptions Scottish Water has used to underpin its draft business plan for the period 2015-21.

Overview of business plan proposals

Inflation

The measure of inflation that is currently used when calculating Scottish Water's charges for each financial year is the retail prices index (RPI). Having discussed the pros and cons of alternative measures of inflation with the Customer Forum, Scottish Water now proposes to use a different measure, the consumer price index (CPI).

In its draft business plan Scottish Water has assumed that CPI will be 2% for each year of the period 2015-21. This forecast has been set in line with the Bank of England's long-term target for CPI.

Table 1: Scottish Water's assumed consumer price inflation

2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
2%	2%	2%	2%	2%	2%

As at previous price reviews, Scottish Water has applied a forecast of RPI to its base year costs to derive outturn expenditure profiles in the business plan. Scottish Water is not proposing to index its capital costs to an alternative measure such as the Construction Output Price Index (COPI), as has historically been common practice elsewhere in the water industry.

Scottish Water has assumed that operating and capital expenditure will inflate by RPI. It assumes RPI will average 2.9% across the period 2015-21. The company has based this forecast on the historic differential between CPI and RPI and on research that the Office for Budget Responsibility has undertaken on the future RPI/CPI differential[1].

Table 2: Scottish Water's assumed retail price inflation

2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
2.9%	2.9%	2.9%	2.9%	2.9%	2.9%

Interest rates on new debt

Although inflation across the economy will affect most of Scottish Water's costs, it does not affect its cash interest payments. Interest payments are determined by the rate at which it can borrow money from the Scottish Government. Scottish Water has made the following assumptions in relation to its average interest rates on new debt for the period 2015-21.

Table 3: Scottish Water's assumed interest rate on new debt

2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
3.5%	3.75%	4%	4%	4%	4%	4%	4%

Our analysis and issues arising

Inflation

The Customer Forum has indicated that CPI is the inflation measure that is most recognised by customers, as it is the UK Government's official measure of inflation. It is also the inflation index that is used to adjust many pensions and benefits.

Our analysis indicates that Scottish Water's forecast CPI of 2% a year is a reasonable assumption. That said, it should be noted that CPI has been above 2% for much of the past ten years and is forecast to continue to remain higher in the near term. If this trend continues charges could ultimately be higher and financial strength potentially improved – but that will depend on how Scottish Water performs during the regulatory control period.

Scottish Water's forecast rate for RPI of 2.9% for each year of the review period is based on an estimated 0.9% difference between RPI and CPI. The gap between RPI and CPI has generally been smaller than this, in the region of 0.75%, in the past 15 years. However, Scottish Water notes that the difference may grow as a result of changes in the way in which prices for clothing are measured.

We note Scottish Water's position on this increase due to clothing prices. However, we think that it would be more appropriate to use the long-term historical average. We would therefore suggest that an assumed difference between RPI and CPI of 0.75% would be reasonable.

[1] The difference between RPI and CPI is due to the composition of the indices and the mathematical formulae that are used to calculate each inflation rate. These differences usually mean that CPI is lower than RPI.

Interest rates on new debt

Our analysis indicates that Scottish Water's assumptions for the average interest rate on new debt for the period 2015-21 is reasonable.

Established forecasts[2] indicate a steady rise in government gilt yields over the next few years which will increase the cost at which Scottish Water is able to finance new borrowing. The only note of caution is that as current rates are at historic lows there is more risk that borrowing costs will be above the forecast levels than there is that they will be below them.

Presentation of prices

Scottish Water's business plan recognises that household budgets remain under some pressure. Normal regulatory practice has been to link prices to RPI. When setting prices for private sector companies, RPI-based price caps help companies to access index-linked debt, which can reduce the current interest charges that have to be paid for by customers.

However, customers may be disappointed if a promised price reduction relative to RPI inflation turns out to be an increase when considered next to the main CPI index.

Scottish Water's suggestion to link prices to CPI inflation may reduce the risk that customers' expectations are not met. An alternative approach may be to set the actual prices (at least for the first few years) that customers will pay. This would ensure that household customers can plan their budgets more easily. Such an approach could fit within the approach that the Commission used at the last Strategic Review of Charges of setting an overall charge cap for the whole regulatory control period.

If the Customer Forum and Scottish Water were to see merit in this suggestion, they may wish to take account of the planned increase (in line with RPI) that is expected to take effect this coming April.

Conclusion

Overall we consider that the financial assumptions that Scottish Water has used to underpin its draft business plan for the period 2015-21 are reasonable. However, we would recommend using an assumed difference between RPI and CPI of 0.75% rather than Scottish Water's assumption of 0.9%.

[2] The National Institute of Economic and Social Research, EY Item Club.

Water Industry Commission for Scotland
First Floor, Moray House, Forthside Way, Stirling FK8 1QZ.
E: enquiries@watercommission.co.uk
T: +44(0) 1786 430200

www.watercommission.co.uk