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Note 17 for the Customer Forum

water industry commission FOR SCOTLAND

Scottish Water's draft business plan: Financial strength and closing cash

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

The customer interest is best served by Scottish Water being a financially sustainable business. It is important that prices are predictable and stable across time. This is best achieved by allowing for consistency in financial strength; the Commission has therefore committed to the financial tramlines[1], which should ensure that the financing of Scottish Water is appropriate for customers of today and tomorrow.

In general terms, Scottish Water should maintain an appropriate level of financial strength to protect against unforeseen shocks in the future. However its financial strength should not be so high that customers are overpaying in the present. Our approach is broadly similar to that of Ofwat, which requires companies south of the border to maintain a strong investment grade credit rating.

This note outlines the Commission's view of the comments on financial strength that Scottish Water has made in its draft business plan.

Overview of Scottish Water's proposals

Scottish Water's business plan suggests that it will:

- achieve an average in interest cover of 1.6x and gearing of 54% over the period 2015-21;
- accumulate £115 million of cash, including £93 million of gilts reserve, by March 2021.

The target level of cash assumes that:

- the Scottish Government will provide £120 million a year of borrowing;

[1] As outlined in the Commission's methodology document, 'Strategic Review of Charges 2015-21: Innovation and choice', the financial tramlines are a measure to monitor and ensure Scottish Water's financial strength and creditworthiness.

- Scottish Water will enter this price control with c£248 million[2] of cash that will primarily be used to finance the capital enhancement programme that was started in the current price control period and will be carried over into the next.

Assessment of Scottish Water's proposals and issues arising

We consider that Scottish Water should maintain strong financial ratios that are broadly consistent with a shadow credit rating of A3/A-. Such strong financial ratios would be broadly consistent with the credit rating of those companies in England and Wales that are not within a securitised financial structure.

Companies not financed within a securitised structure will typically seek to satisfy Ofwat's requirement to maintain a strong investment grade rating in their core business by targeting gearing around 60-65% and cash interest cover of 1.6-1.8x. Unlike companies in England and Wales, Scottish Water has no access to index linked borrowing. As a consequence, in comparison with its peers, Scottish Water's gearing will appear strong while its interest cover will look weak.

It is therefore important to look at these financial ratios together rather than individually when assessing financial strength. Our approach is to set prices consistent with Scottish Water achieving the targeted financial strength at the end of the regulatory control period. Under the expected borrowing profile, Scottish Water should have the financial resources that it requires to deliver the ministerial objectives and the improvements that the Customer Forum would like to see. We therefore consider that Scottish Water is targeting an appropriate level of financial strength.

In outlining how we would apply the financial tramlines, we sought a balance between allowing for customers to benefit from any outperformance as early as possible and the potential for performance in any single year to be unrepresentative of Scottish Water's underlying performance.

Table 1: Credit ratings (as at October 2013)

Company	Ratings from Moody's
Anglian Water Services Ltd	Baa1
Northumbrian Water Ltd	Baa1
Severn Trent Water Ltd	A3
Southern Water Ltd	Baa2
Thames Water Utilities Ltd	Baa1
Dwr Cymru Welsh Water	A3
UU Water Plc	A3
Wessex Water Services Limited	A3
Yorkshire Water Service Limited	Baa1

[2] Based on the assumption that charges increase by RPI in 2014-15.

The borrowing available to Scottish Water is expected to be £120 million a year for each year of the six-year period 2015-16 to 2020-21. Scottish Water's draft business plan includes assumptions on:

- opening and closing cash balances; and
- operating cashflows.

Scottish Water's draft business plan sets out what it considers to be the most likely outcome, but there is also an equal chance of over- or underperformance. The Commission's tramlines approach provides assurance to Scottish Water that its financial strength will be maintained in the long term beyond this price review. Our view, therefore, is that a closing cash balance in the gilts buffer (assuming performance in line with the regulatory contract) should be in the range of £20-£40 million.

This suggests that between £75 and £95 million may be used to reduce customers' bills or to finance further service improvements for customers. A reduced cash balance at the end of the regulatory control period would imply lower prices and, as such, reduced financial strength (measured on a like for like basis). In our view, when financial strength is restated on a basis broadly comparable to financing of the companies south of the border, there is scope to reduce the closing cash balance. We would be happy to model scenarios for the Customer Forum. It is, of course, possible that the ending cash balance will be higher if Scottish Water outperforms its regulatory contract.

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