Our initial expectations: Note 4 for the Customer Forum

water industry commission FOR SCOTLAND

Improving services in times of constrained borrowing

This note gives an outline of our initial expectations of how Scottish Water can deliver improvements to services despite the likely constraints on its borrowing over the 2015-20 regulatory period.

Key messages

The average amount of borrowing that the Scottish Government makes available to Scottish Water in the current regulatory period has decreased from £140 million a year to around £85 million a year. In its recent consultation[1], the Scottish Government indicated that borrowing by Scottish Water over the next period, 2015-20, will be at a lower level than the amount that has been available for 2010-15, although no figures were proposed.

Scottish Water has managed the current reduction in borrowing without any shortfall to date in the delivery of the improvements required by Ministers. In large part it has achieved this by applying the cash surplus that it has generated through outperformance. A further reduction from 2015 may well prove more challenging.

We therefore expect Scottish Water to continue to seek out and pursue opportunities to generate additional cash from within the business. This may be, for example, through leasing or renting services rather than buying them, where this is cost effective.

We also expect Scottish Water to exploit actively the changes that we have made to our regulatory approach to encourage innovative solutions, in particular those that would allow improvements to be delivered with less initial cash outlay than with a more traditional engineering approach. We recognise that moving away from traditional approaches is a gradual process, but it should be sustained year on year.

Introduction

Scottish Water finances its delivery of improvements to services mainly through a combination of customers' charges and government borrowing. It also uses cash savings generated in the business. In that context, this note brings three issues to the attention of the Customer Forum:

- the potential impact of a likely reduction in the level of cash available to Scottish Water during the period 2015-20, due to constraints on new borrowing;
- the scope for Scottish Water to identify new sources of extra cash from within the business; and
- the opportunity for Scottish Water to find new ways to deliver improvements, such that they require less initial cash outlay.

This note outlines our understanding of the position regarding borrowing for the next regulatory period. It then explains our expectations on how Scottish Water could continue to deliver significant improvements despite this constraint. Our explanation touches on a number of complex areas, and so we remind the Customer Forum that we are available to provide further material and to answer questions.

The principal themes that we cover concern the importance of the business continuing to focus on cash, that decisions about the timing of investment are critical, and how changes we have made to the regulatory framework will encourage new approaches and over time will help reduce the requirement for borrowing.

[1] Scottish Government engagement paper 'Investing In and Paying for Your Water Services from 2015', June 2012.

Drivers for improvement

Scottish Ministers set the high-level objectives that Scottish Water must deliver during each regulatory period. As well as requiring Scottish Water to maintain current levels of drinking water quality, environmental performance and customer service, Ministers' objectives also set out expected improvements in service and the required timescales. These improvements can be driven by a range of factors including increased water quality or environmental performance standards resulting from EU or UK legislation, expectations of higher customer service levels (for example in tackling low water pressure or reducing odour) or Scottish Government policy in areas such as carbon reduction or facilitating growth. Typically, around half of Scottish Water's investment programme is focused on delivering such service improvements while the other half is focused on maintaining current levels of service.

Paying for improvements to service

Scottish Water has three sources of cash to pay for improvements to services:

- the cash it receives from customers, less what it spends to deliver the basic service;
- the cash it receives as new borrowing from the Scottish Government; and
- any cash savings that it can make through outperformance, property disposals and changes to how it procures services.

Looking at improvements over the last decade, we estimate that the relative overall contribution from these three sources – in very round percentage terms – amounts to some 55% from customers, 40% from borrowing and around 5% from outperformance etc.

These broad proportions were set to continue. In 2009 we set prices on the basis that Scottish Water would be able to borrow up to £140 million a year over the regulatory period 2010-15. However, the Scottish Government later reduced the available borrowing for the period, so that it is likely to average around £85 million a year. Fortunately, Scottish Water is able to make up the resulting shortfall in cash mainly from outperformance savings that it generated in the previous regulatory control period (2006 to 2010).

Scottish Water cannot necessarily rely on future outperformance savings continuing at the levels that were achieved previously, particularly as customer bills have increased by less than inflation for several years.

The Scottish Government has not yet indicated the scale of the reduction in borrowing beyond 2015. However, it would seem prudent to plan on the basis of borrowing being at most £60 million to £80 million a year. If Scottish Water focuses on value for money and new opportunities presented by changes to our regulatory approach, it should be able to continue to deliver improvements in spite of this lower level of borrowing.

Generating additional cash within the business

In the past Scottish Water has generated some additional cash from the sale of surplus property. We expect it to continue to pursue opportunities in this area.

Further opportunities to generate additional cash may well be available if Scottish Water is able to change the way in which it procures some services, for example by leasing or renting services instead of buying them. We would expect Scottish Water to highlight such initiatives in its business plan.

Reducing initial cash outlay

Where Scottish Water invests in traditional solutions to maintain or improve services, there is an initial cash outlay to pay for the design and construction work, and for the materials that are required. For example, in order to maintain existing services, Scottish Water may plan to replace assets such as water mains and treatment facilities that are nearing the end of their useful physical lives, and do so before the assets fail. Similarly, an improvement in drinking water quality or environmental performance would usually be made by building additional assets, for example to provide additional treatment processes. Where an improvement is directed at customer service, for example to reduce flooding of properties from sewers, this would often entail the provision of a new asset, such as a larger sewer. Indeed, the traditional approach in the water industry in the UK is to favour the building of new assets over less capital intensive approaches.

The initial cash outlay on new assets could, in some cases, and with the agreement of the Scottish Environmental Protection Agency (SEPA) or the Drinking Water Quality Regulator (DWQR), be either delayed or avoided, freeing up cash for other priorities. A delay would require Scottish Water to identify a temporary alternative solution that met the maintenance need or improvement required without having to replace or build a capital asset. Such a solution could be replaced by a permanent solution at a later date.

If an initial cash outlay is to be avoided rather than just delayed, it is likely that an innovative approach will be required. For example, improvements in the treatment of water or waste water could in some cases be helped, through working with land agents and farmers to achieve an operational, and more sustainable, solution. Although the industry has limited experience of these innovative approaches, there is increasing evidence from companies that they could generate significant cost savings and improved environmental performance. Such approaches may entail some increased financial risk, but the gains could be substantial and, over a portfolio of projects, these risks can be managed.

Where improvements are specified by SEPA or by DWQR, Scottish Water will need to seek the agreement of these organisations to any innovative solutions. However they have already shown that they are willing to engage in exploring opportunities of this type. There should in some cases be scope for a range of solutions that are acceptable to SEPA and DWQR, where the Customer Forum could negotiate with Scottish Water on the precise selection.

In other cases, for example where the improvement relates to a particular customer service not specified by SEPA or DWQR, such as reducing interruptions to supply or reducing flooding of properties from sewers, the Customer Forum should negotiate solutions directly with Scottish Water.

Our expectations for 2015-20

Under the proposed changes to the regulatory approach set out in our Methodology document[2], we aim to ensure that there is no bias in the current approach in favour of either operating or capital expenditure as a means of delivering improvements.

We also propose to ensure that Scottish Water has sufficient finance to allow for the risk that some of these alternative solutions will not deliver the required output and a more traditional solution will ultimately be required. Our aim in doing this is to remove any regulatory barriers to Scottish Water considering alternative solutions of the kind outlined above.

It will be for Scottish Water to propose in its Business Plan whether, when and how to consider opportunities to generate cash or to reduce cash outlay, based on detailed business information, and where appropriate, the requirements of SEPA and DWQR. As such, we are not in a position to indicate the scale of these opportunities. However, this note does indicate the potential scale of the challenge brought about by constraints on borrowing and the importance of Scottish Water more actively pursuing opportunities for novel approaches to delivering service improvements.

[2] For further details of these proposals, see Section 4 of the Executive Summary of our methodology.

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