Our initial expectations: Note 6 for the Customer Forum

Sustainable funding by customers

This note outlines areas where it may be possible for engagement between the Customer Forum and Scottish Water in agreeing improvements in services during the 2015-20 regulatory period. Any such decisions must be consistent with sustainable funding.

Key messages

There is likely to be considerable scope for engagement between the Customer Forum and Scottish Water in relation to two areas of service improvement. These are: the extent of discretionary service improvements that Scottish Water may make, and the approach that is used, or the timing, of some of the statutory improvements that it must deliver. In the latter case, there will only be room for manoeuvre in specific circumstances.

The extent of opportunities in this area will depend on relatively small changes in how improvements are delivered, trade-offs between service and price, and the pace of efficiency improvements.

Introduction

Scottish Ministers determine overall policy for the industry and high-level objectives for customer service, water quality and environmental improvement that Scottish Water must deliver.
The Commission and Scottish Water then work within the limits set by these objectives, which shape the overall outcome of a price review.

In Note 4 we considered the limits that Ministers are likely to place on the level of annual borrowing that is available to Scottish Water. In Note 5 we touched on the upper and lower limits on the size of Scottish Water's investment programme.

In this note and the accompanying Note 7 (Financial tramlines) we consider a third requirement that Ministers have proposed. This is that charges for customers should ensure the sustainable funding of the water industry[1] in the long term.

Sustainable funding of improvements to services

Like all other water and sewerage companies, Scottish Water makes improvements to services year on year. Many, but not all of these improvements are driven by the need to comply with increasing statutory requirements in the quality of drinking water and the impact of the service on the environment.

Most improvements in services are delivered through capital investment. As we outlined in Note 4, slightly more than half of the cash that is required to pay for these improvements comes from revenue from customers.

If Scottish Water were not required to make such improvements, charges for customers would be lower, and would gradually decrease over time (relative to inflation). This is because the cost of delivering a static, baseline service would decline as efficiencies are found. In addition, as no new borrowing would be required, annual fixed interest payments would not grow year on year.

[1] Ministers' proposed principles of charging are set out in *Investing in and Paying for Your Water Services from 2015*, The Scottish Government, 2012, (see page 12 regarding sustainable funding).

In broad terms, it follows that continuing improvements can be funded sustainably without increasing prices to customers above inflation, as long as the cost of financing the improvements is no greater than the annual efficiencies that can be found across the business.

For example, at the last price review we set overall charges to fall by 1% a year relative to RPI. This was sufficient to cover the costs of all of the improvements. Had there been no such statutory or other improvements to pay for, charges could have fallen by around 4% a year relative to RPI.

The next price review will need to consider the full range of new improvements to be paid for by customers to meet both statutory obligations and any non-statutory objectives that Ministers set. It is reasonable to assume that the impact of these improvements on prices will be similar to the last price review. In other words, prices may be 3% higher than they would otherwise have been were no improvements required. For this reason it is very important that customers' willingness to pay for these improvements has been properly tested, where appropriate.

The scope for engagement and trade-offs between service and price

In our view there is still significant scope for engagement between the Customer Forum and Scottish Water (and where appropriate, with the quality regulators SEPA and DWQR) in relation to Ministers' requirements. This concerns not only agreement on discretionary improvements but also, where there is more than one acceptable technical option, in relation to some of the mandatory improvements to be delivered (as we outline in Note 4). There are three important factors to consider:

1. In some cases Scottish Water will identify more than one technical option that is acceptable to SEPA or DWQR as to how a mandatory improvement is to be delivered, and consequently its cost and perhaps risk profile. These choices could have a direct impact on the amount of cash that then remains available for discretionary improvements.

   As a broad illustration, if the process of engagement in such cases were to reduce the overall cost of future mandatory improvements by just 2% over 2015-20, this could generate around £25 million of additional cash (in current prices). This extra cash could be used to provide further discretionary improvements in services, without affecting charges.

2. A small adjustment to charges can be sufficient to finance significant cash spend on improvements.

   For example, ½% added to charges every year over the period 2015-20 would generate around £75 million of extra cash (before tax).

3. The speed with which Scottish Water is able to make efficiency gains in its expenditure is a critical factor in determining the amount of cash that is freed up for improvements in services.

   Were Scottish Water to deliver an extra ½% a year of efficiency in its operating and capital expenditure over the period 2015-20, this would generate additional cash of around £60 million.

It is likely that these illustrative examples are conservative. Depending on both Scottish Water's financial strength and the availability of borrowing, it may be possible to use part of the cash savings in these three illustrations to cover the interest cost on new loans. Taking the third illustration, for example, if half of the cash savings from better efficiency were used to finance new loans, then Scottish Water could have around £200 million extra cash available for improvements to services over the period 2015-20, subject to available borrowing. All of this could be used to provide additional improvements.

Alternatively, again taking the example of the efficiency savings, these could be used to keep charges down rather than to pay for additional services. For example, an extra ½% a year efficiency in operating and capital expenditure would allow household charges to be around £5 a year lower by 2020 than they would have been.

Although these are only illustrations, they demonstrate that there is likely to be scope for the Customer Forum to influence a substantial amount of discretionary expenditure over the 2015-20 period through its choices on delivery solutions, price profiles and influencing the pace of Scottish Water's efficiency improvements.

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