

Initial prospects for prices

This note outlines initial prospects for prices, taking account of the operating range set out in the Scottish Ministers' objectives for the industry. It also gives a preliminary indication of the scope for sustainable outcomes.

Key messages

Maintaining Scottish Water's future investment programme within the ranges proposed by Ministers – whilst also maintaining its financial strength – is likely to require prices that are close to current levels, in real terms.

This outcome would be consistent with Ministers' policy of charges rising by no more than the rate of inflation.

Ministers have recently signalled that there may be limitations on Scottish Water's future access to borrowing. These could act as a further constraint on the outcome of the 2014 price review.

Introduction

In previous notes we highlighted the factors that are likely to affect Scottish Water in the next regulatory period – including limitations on the level of borrowing and the size of the capital programme, and the need for sustainable funding from customers. We also outlined our expectations on how Scottish Water could mitigate the impact of these constraints, and the role of the Customer Forum in that process. This note provides an initial indication of the impact of these factors on future prices. Other than the expectation that less government borrowing may be available, these limiting factors have not changed substantially from previous price reviews.

Implications for charges

Together, these limiting factors determine the scope of outcomes for levels of investment, borrowing, financial health and customer charges.

The extent of sustainable outcomes in these four areas will become clearer as information emerges during the price review process. However, at this early stage, it is possible to set out preliminary assumptions about the factors that affect charges¹. This allows us to establish an initial indication of the scope for outcomes for the 2014 price review.

We have indicated on the figure overleaf the combinations of annual charge increases and levels of borrowing that should result in both levels of investment and levels of financial strength that are within the broad ranges indicated by Ministers (based on our initial analysis in this area).

¹ For example operating expenditure, growth in the customer base, interest rates and tax.

Note 8: Initial prospects for prices

Amber shading indicates borderline combinations where the limiting factors may, or may not, be achieved.

Red areas are as follows:

- upper left: there is a risk that the financial ratios that determine financial strength will be too weak, suggesting insufficient finance in the longer term and unstable charges;
- lower right: there is a risk that the financial ratios will too strong, suggesting that today's customers are paying too much;
- upper right: there is a risk that annual investment will be more than £500 million, which is beyond the Ministers' preferred range and may impact on the efficiency of delivery; and
- lower left: there is a risk that annual investment will be less than £450 million, which is beyond the Ministers' preferred range and may be insufficient to maintain and improve service.

The area bordered in black is where borrowing would not be less than the current level in real terms². Ministers have indicated that they expect Scottish Water's public borrowing in the next regulatory period to be lower than the current level.

| | Annual charge increase 2015-20, relative to inflation | | | | | | | |
|--------------------------|---|-------|--------|-------------|-------------|-------------|--------|-------|
| Annual borrowing 2015-20 | -1.25% | -1% | -0.75% | -0.5% | -0.25% | 0% | +0.25% | +0.5% |
| £140m | Red | Red | Red | Amber | Amber | Red | Red | Red |
| £120m (current level) | Red | Red | Amber | Light Green | Light Green | Light Green | Amber | Red |
| £100m | Red | Amber | Amber | Light Green | Light Green | Light Green | Amber | Red |
| £80m | Red | Red | Amber | Amber | Light Green | Amber | Amber | Red |
| £60m | Red | Red | Red | Red | Red | Amber | Red | Red |
| £40m | Red | Red | Red | Red | Red | Red | Red | Red |

² It may become possible to consider outcomes inside the black area if Scottish Water is able to access the bond market or develop new models of project finance such as the Scottish Futures Trust's Non-Profit Distributing model.

This preliminary assessment suggests that Scottish Water should be able to propose improvements in service and in efficiency such that prices and borrowing fall within the combinations shaded green or amber in this figure and maintain appropriate financial strength.

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