water industry commission FOR SCOTLAND

Initial Decision Paper 12: Financial strategy

This is the twelfth in a series of Initial Decision Papers that the Water Industry Commission for Scotland will publish during the Strategic Review of Charges 2021-27. The Commission will issue initial, revised and final Decision Papers. These Initial Decision Papers set out, for customers and other stakeholders, the Commission's current views on important matters relating to the Strategic Review of Charges 2021-27. They will provide the Commission's views on:

- **Strategic issues facing the industry that will impact levels of service beyond the next regulatory control period;**
- **The prospects for customers' charges during the next regulatory control period;**
- **Issues that directly and materially impact the charges that customers will pay in the next regulatory control period;**
- **The potential for Scottish Water to engage even more effectively with its customers; and**
- **The approach to the Strategic Review of Charges 2021-27.**

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review[1], taking account of all the evidence available to it in coming to the views set out in these Initial Decision Papers.

In line with the Cooperation Agreement signed with Scottish Water and Citizens Advice Scotland, the Commission would be minded to adopt a business plan that is consistent with the Commission's Final Decision Papers and agreed with the Customer Forum as its Draft Determination.

This twelfth Initial Decision Paper sets out the Commission's view on the key themes that will shape the discussion on the future funding and financing arrangements for the water industry in Scotland.

Key messages

Scottish Water's financial performance has improved substantially since it was established in 2002. At that time, its financial strength lagged that of most of the privatised companies south of the border. Scottish Water now has the strongest balance sheet of any of the UK water and sewerage companies.

It now appears that 'enhancement' investment in improving the quality and resilience of our water supply and the collection and treatment of waste water will continue at around current levels for the foreseeable future. As such, it would seem imprudent simply to borrow the cost of all of these improvements. Borrowing would pass the cost onto future generations of customers.

Scottish Water should seek to borrow where there is a timing difference in its income and expenditure. It should also borrow for demonstrably one-off projects such as improving resilience or to address growth.

It appears likely that Scottish Water may have to commit an increased level of resources to the maintenance and replacement of its assets. More work is still required to assess the extent of this challenge. However, burdening future generations with both a higher level of maintenance expenditure and the interest on borrowing to enhance current services would seem unreasonable. Indeed, it seems likely that current customers should be making a greater contribution to ensuring long term asset maintenance.

1 'Innovation and Collaboration: future proofing the water industry for customers', published on 10 April 2017 and available on the Commission's website.

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Scottish customers benefit because Scottish Water remains in the public sector. This reduces the cost of borrowing and the Scottish Government has not asked for a dividend. Our analysis estimates that average household bills would have been £84 higher (23%), had Scottish Water paid a commercial rate of interest and a dividend consistent with that allowed for by Ofwat when it sets prices for companies south of the border.

Scottish Water's financial strength will make it easier to address the challenges that lie ahead. We must, however, continue to act prudently.

Background

The Water Industry Commission for Scotland has a general duty to promote the interests of customers, both current and future. This requires setting charges that are consistent with the Principles of Charging set out by Scottish Ministers and with the lowest reasonable overall cost that Scottish Water should incur in meeting the Objectives set for the industry by Scottish Ministers.

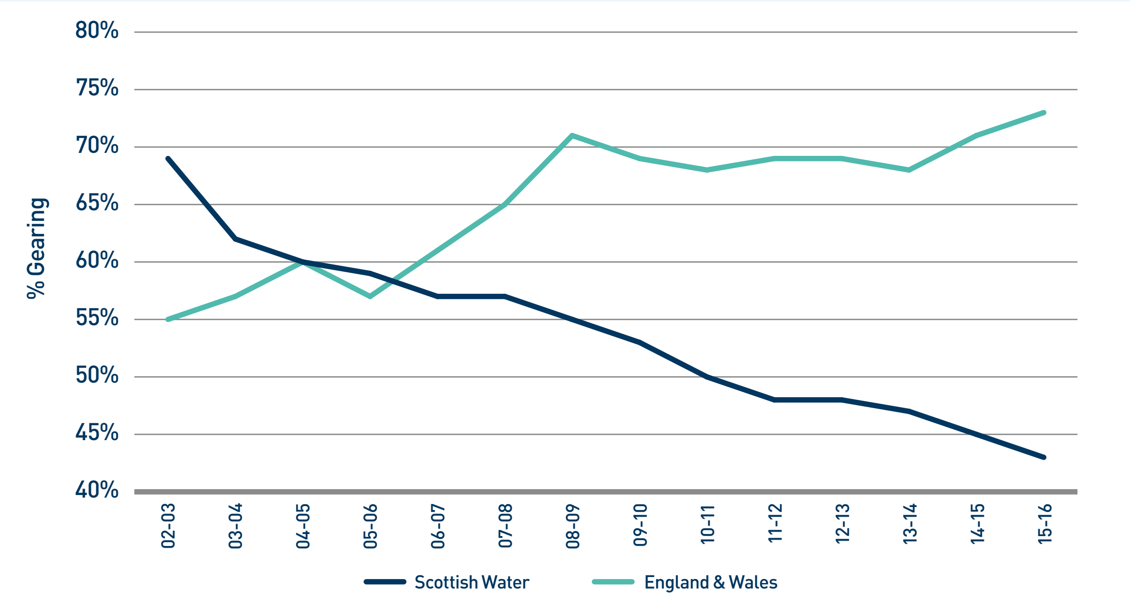
In setting charges, the Commission has to consider the cash resources that Scottish Water will need over the regulatory control period, and ensure that an appropriate balance is achieved between funding (the revenue collected from customers) and financing (the loans received from the Scottish Government).

Best practice would require a water company to recover its operating, financing and maintenance costs entirely through revenue, and only borrow to finance those capital investment projects that are truly one-off and incremental in their nature – any recurring capital expenditure should normally be funded through revenue.

Following the merger of the three Water Authorities, the financial position of the water industry in Scotland has improved significantly. In recent years, Scottish Water has generally recovered over 90% of its costs (including capital investment) from its customers.

Since 2002, when Scottish Water was established, its gearing (the level of net debt relative to its regulatory asset base) has fallen from around 70% to below 45%; during the same period, the total gearing level of the water industry in England and Wales has moved markedly in the opposite direction, rising from 55% to almost 75%.

Figure 1. Scottish Water's gearing and total gearing in England and Wales



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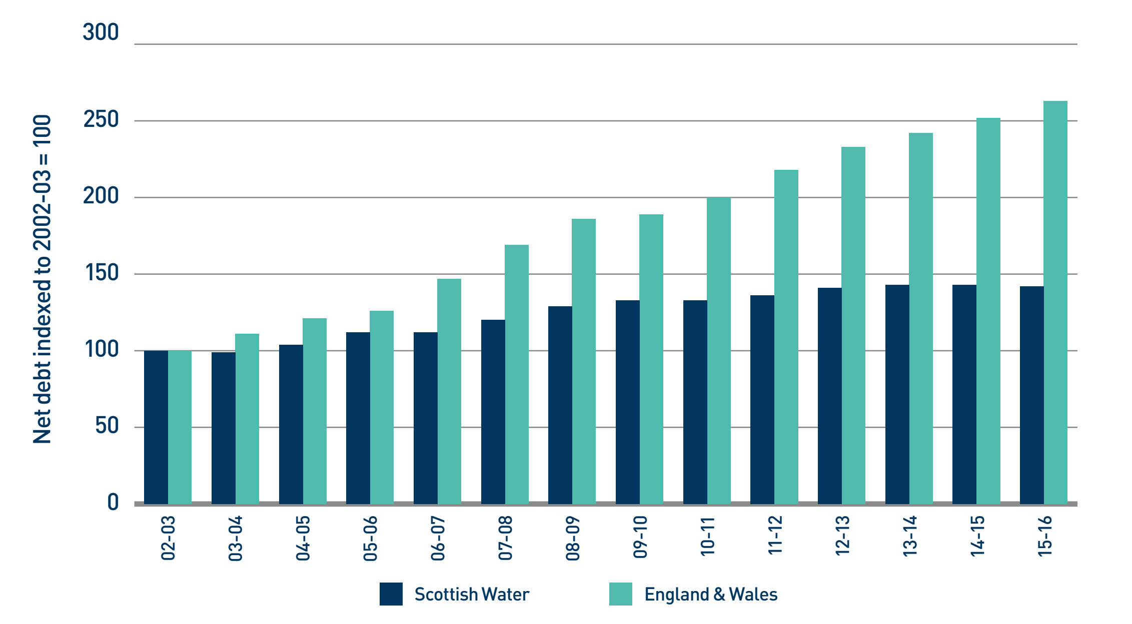
Total net debt[2] in the water industry in Scotland has grown more slowly than the overall asset base. Overall, between 2002 and 2016, the net debt on Scottish Water's balance sheet increased by just over 40% (and has remained broadly stable since 2012-13). In England, total net debt has grown much quicker – by over 160%. All else being equal, this will mean that future customers in Scotland are likely to face lower increases in charges than in England – assuming that the future investment and operating challenges are broadly similar.

Figure 2. Scottish Water's net debt and the total net debt in England and Wales (2002-03 net debt level = 100)s



Scottish Water is now on a strong financial footing, and well positioned to start addressing the challenges that the industry faces going forward.

Future challenges

In our Initial Decision Paper 1 "What impacts prices?"[3], we explained the extent to which the level of capital expenditure and borrowing impact prices. Other Initial Decision Papers[4] have set out the areas where Scottish Water may have to invest more in future.

Capital Maintenance

As discussed in Initial Decision Paper 7, the level of expenditure on capital maintenance and asset replacement is currently uncertain, but high level analysis would suggest that the current level of expenditure is unlikely to be sufficient in the future. This is because the implied expected life of assets appears to be unrealistic – especially when a comparison is made with the assets that Scottish Water currently operates.

However, this does not mean that more needs to be spent today or even in the next several years. It is possible that Scottish Water could maintain current levels of service with modest increases in its maintenance budget. There are three challenges:

1. What is the current condition of the assets and what would be an appropriate maintenance and replacement schedule?
2. How should the cost of asset maintenance and replacement be spread between todays and future customers?
3. How do we make progress in the next regulatory control period given that the information available is not as complete as we might like?

2
Net debt is the gross debt minus the cash in short term deposits.

3
Published in June 2017 and available on our website.

4
Initial Decision Paper 4 "Overall size of the capital programme", Initial Decision Paper 7 "Futureproofing service levels: sustainable asset maintenance", Initial Decision Paper 8 "Enhancement investment" and Initial Decision Paper 9 "Growth investment".

Joint work with Scottish Water is already underway to understand the implications of asset maintenance and replacement on future customers. Scottish Water is planning an assessment of the condition of its assets and considering how this information can be kept current.

The most immediate challenge is the third. It would seem reasonable to allow for steady increases in capital maintenance allowances but, in so doing, stakeholders will want to be reassured that this expenditure is only committed when it is required. At the current time, we, and other stakeholders, have only a limited insight as to how the maintenance allowances are used. It would be helpful if Scottish Water could bring forward proposals for how:

- customers could be reassured that capital maintenance allowances are being spent effectively;
- progress can be made in establishing the likely future level of expenditure requirement; and,
- an effective budget constraint can be maintained throughout to ensure value for money.

This is an area where it will be particularly important for Scottish Water to win the trust of its customers and stakeholders.

Lower borrowing

We reflected earlier on the potential scope for additional borrowing given the strength of Scottish Water's balance sheet. It is important to note that, in its Commissioning letter for the Strategic Review of Charges 2021-27[5], the Scottish Government has indicated that the level of borrowing that it will make available will likely be lower than in previous regulatory control periods.

In Initial Decision Paper 1 we discussed the impact of borrowing on prices.

Scottish Water's income and expenditure can vary year on year and across regulatory periods, depending on the timing of the investment programme and the incidence of costs. Scottish Water may require borrowing to smooth out these variations.

The status of Scottish Water

In Scotland, we have benefitted considerably by being able to compare the performance (both in terms of costs and levels of service) of Scottish Water with the water and sewerage companies south of the border. Indeed, one of the reasons for establishing Scottish Water was to improve the relative performance of the water industry in Scotland. As we have noted elsewhere in these Initial Decision Papers, Scottish Water's performance now compares very favourably, although we can still identify areas where relative performance could be better.

There appears to remain a strong consensus on maintaining Scottish Water in public ownership. At the current time, Scottish Water is a very valuable asset (certainly worth in excess of £6-7 Billion on the basis of recent transactions south of the border), however it is only likely to get more valuable. The financial and service level performance of Scottish Water is improving year on year.

It appears that customers have benefited from public ownership. Scottish Water borrows at interest rates that are only marginally higher than those paid by Government. These are typically at least 100 basis points (1%) lower than the borrowing costs of the privatised companies south of the border. One percent may not sound like much, but it equates to £10 million pounds a year for every billion pounds of borrowing. Scottish Water currently borrows £3.4 billion. This extra borrowing cost alone would add some 3% to the average household bill.

More importantly, however, Scottish Water does not pay any dividend to the Scottish Government. If we were to assume that Scottish Water paid out in dividend the Ofwat allowed for cost of equity on the unleveraged portion of its regulatory capital value, we would have had to set charges around 20% higher.

5
The Scottish Government's Commissioning letter for SRC 2021-27 is published as Appendix 1 of our methodology document 'Innovation and Collaboration', which is available on our website.

The total effect on the current average annual bill in Scotland of these two immediate benefits of public ownership is around £84. In other words, all else being equal, customers in Scotland would face an average annual bill around 23% higher if the industry were to be privatised.

Our analysis of the impact on customers' bills is probably understated. This is for three reasons. Firstly, the privatised water companies paid a higher dividend than we have included in our calculation. Scottish Water would likely have paid out the benefits of its outperformance of its regulatory contract. Scottish Water reinvests this out-performance and bills are lower as a direct result. Second, after privatisation, customers would receive no further benefit from future outperformance within a regulatory control period. Lastly, experience from England suggests that a privatised company could seek to maximise its current return at the expense of future customers by increasing its level of borrowing.

Conclusion

Scottish Water's financial strength has improved markedly. Its balance sheet is stronger than that of the other water and sewerage companies in Great Britain. The resulting lower interest costs ensures that more environmental improvements and better levels of service can be afforded for a given level of charges.

There is no room for complacency. Scottish Water appears likely to face a significant asset maintenance and replacement challenge over very many years. There is a lot of work to be done to understand the potential cost of this to customers and how we can best prepare to meet this challenge. Scottish Water recognises the challenge and understands what steps it needs to take to build the confidence of its customers and other stakeholders. More immediately, Scottish Water will have to set out in its business plan how we can make progress during the next regulatory control period.

Addressing the capital maintenance and asset replacement challenge may put an upward pressure on charges. But higher levels of borrowing are unlikely to be the answer as this will simply increase prices. This would not be good for customers either now or in the future.