water industry commission FOR SCOTLAND

# Initial Decision Paper 1: What impacts prices?

**This is the first in a series of Initial Decision Papers that the Water Industry Commission 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 first Initial Decision Paper sets out the Commission's current view on the relative impact on prices of the various inputs to the Strategic Review of Charges 2021-27.**

## Key messages

The level of funding required by Scottish Water over the course of a regulatory control period is largely determined by nine key factors. Changes in any of these factors impact Scottish Water's overall funding requirement and, therefore, the change in average annual charges over the regulatory control period.

Our analysis suggests that, among those factors that are controllable, the allowed for level of capital expenditure and the level of borrowing available from the Scottish Government have the most material impact on charges.

## Introduction

The Water Industry Commission for Scotland has a general duty to promote the interests of customers. In so doing, it should also have regard to the interests of future customers and those that live in rural areas. Its principal task is to set charges that are consistent with the lowest reasonable overall cost that Scottish Water should incur in meeting the Objectives set for the industry by the Scottish Ministers. The charges set by the Commission also need to be consistent with the Principles of Charging set out by the Scottish Ministers.

The Commission has, in effect, to consider the cash resources that Scottish Water will need over the regulatory control period. The level of borrowing available to Scottish Water is capped: the Commission could decide to advise the Scottish Ministers to make less borrowing available to Scottish Water, but could not decide that more borrowing would be appropriate.

This borrowing cap applies irrespective of the source of the debt finance (for example, Scottish Water's overdraft facility at the Bank of Scotland). As such, it is important to think carefully about the factors that influence (in cash terms) the revenue that Scottish Water will receive and the costs that it will incur.

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

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## The key variables

There are nine inputs that materially affect Scottish Water's funding requirement (and, therefore, its charges). We have tested other potential drivers of cost (such as working capital) and concluded that they have no material impact.

These nine inputs are:

1. Growth in the household customer base;
2. Growth in the non-household customer base;
3. Net new borrowing;
4. Operating expenditure;
5. Capital maintenance expenditure;
6. Capital enhancement expenditure;
7. Capital expenditure to increase the number of connections to the water and sewerage service;
8. Cost inflation; and
9. Interest rates.

The first three inputs impact on the cash available to Scottish Water. Increases in these inputs tend to reduce the requirement[2] for an immediate increase in the level of customers' charges. Growth in the customer base influences the level of revenue that Scottish Water would receive for any given set of tariffs. Net new borrowing supplements the allowed for revenue from customers. In considering these three factors, it is important to note that substituting borrowing for revenue from customers does not work on a pound for pound basis:

- Additional borrowing increases the interest charges faced by Scottish Water; and
- Net new debt can meet the need for cash in a single year, but additional borrowing would be required each year if there is not to be an increase in customers' charges. As such, net new debt can delay the impact of an increase in charges, but cannot remove the long term need for the increase.

The other six impact on the costs that Scottish Water incurs in its day-to-day operations and in meeting the objectives set for the industry by the Scottish Ministers.

Increases in any of these six inputs will put an upward pressure on charges to customers. Charges would have to increase if no reductions in other cost inputs were identified. In assessing the relative influence of each of these inputs, there are two main factors to consider:

- The sensitivity of prices to changes in each input; and
- How much each input is likely to change over the course of the regulatory control period.

**2**
New connections reduce prices in the medium term. They generally take a few years to pay back.

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## Impact on prices

We have analysed the impact on charges of a change in each of these key inputs. There is a wide range of potential charge outcomes that are possible depending on the programme of capital expenditure agreed and the borrowing that is available. These are illustrated in Initial Decision Paper 2.

Table 1 on the next page provides a 'Ready Reckoner' that illustrates the impact on the average household bill by the end of the next regulatory control period (i.e. in 2026-27).

We have developed this 'Ready Reckoner' to assist the Customer Forum and other stakeholders in understanding the likely impact on charges of Scottish Water's proposals in its business plan. The 'Ready Reckoner' sets out two scenarios.

In the first scenarios (Table 1 in Initial Decision Paper 2) the changes in customers' charges are limited to the 6-year regulatory control period that begins in 2021. Under this scenario, the current Strategic Review of Charges would run its currently planned course. This scenario would keep customers' charges slightly lower than under scenario 2 for longer (until approximately 2024-25) but lead to higher bills by the end of the regulatory control period in 2027. The annual increase required in each year from 2021 to 2027 would be higher than under the second scenario. Under a base case assumption of £80 million of annual net new borrowing and our use of the Bank of England inflation target, this scenario suggests annual charge increases of around 3.0% nominal each year from 2021-22. This would suggest a projected 2026- 27 average household bill of £371 in today's money and around £444 in our assumption of 2026-27 prices.

The second scenario (Table 2 in Initial Decision Paper 2) assumes that the change in customers' charges is smoothed over the final two years of the current regulatory control period (2019-20 and 2020-21) and the whole of the 2021-27 regulatory control period. This reduces the annual increase in charges that would be required. It also results in lower average charges at the end of the regulatory control period. It should be noted, however, that, under this approach, customers pay a little more during the 8-year period 2019-27 (less than £2.50 a year, for the majority of household customers). Under a base case assumption of £80 million of annual net new borrowing and our use of the Bank of England inflation target, this scenario suggests annual charge increases of around 2.4% nominal each year from 2019-20. This would suggest a projected 2026-27 average household bill of £367 in today's money and around £438 in our assumption of 2026-27 prices.

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**Table 1**

## Ready Reckoner

**Impact on average household bill in 2026-27 from a change in the base case**

| Average household bill | Current year 2017-18 | Projected 2026-27[3] | |
|---|---|---|---|
| | | Assuming 6-year adjustment period | Assuming 8-year adjustment period |
| Nominal[4] | **£357** | **£444** | **£438** |
| Current prices | **£357** | **£371** | **£367** |

### Factors where an increase results in increasing prices

| Cash out | Base case (per annum) | Annual change during 2021-27 | Indicative impact of change on average bill in 2026-27 | |
|---|---|---|---|---|
| | | | Assuming 6-year adjustment period | Assuming 8-year adjustment period |
| Capital expenditure* | **£600m** | **+ £10m** | **+ £6.75** | **+ £5.50** |
| Operating expenditure* | **£350m** | **+ £2m** | **+ £1.25** | **+ £1.00** |
| Cost inflation | **2.0%** | **+ 0.10%** | **+ £2.50** | **+ £2.00** |
| Interest rates | **3.0%** | **+ 0.50%** | **+ £1.50** | **+ £1.25** |

### Factors where an increase results in decreasing prices

| Cash in | Base case (per annum) | Annual change during 2021-27 | Indicative impact of change on average bill in 2026-27 | |
|---|---|---|---|---|
| | | | Assuming 6-year adjustment period | Assuming 8-year adjustment period |
| Net new borrowing** | **£80m** | **+ £10m** | **- £5.25** | **- £4.00** |
| Household growth | **0.9%** | **+ 0.10%** | **- £1.75** | **- £1.50** |
| Non-household growth | **0.0%** | **+ 0.50%** | **- £3.50** | **- £2.75** |

* Real terms (12-13 prices). We have used 2012-13 prices at this stage to allow comparison with the previous regulatory period. This will be updated later in the SRC process.

** Outturn

3 The average household bill in 2026-27 is estimated under the two alternative price scenarios described in Paper 2 'Prospects for prices'.

4 Assuming Bank of England inflation target is met.