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water industry commission FOR SCOTLAND

Initial Decision Paper 2: Prospects for prices

This is the second 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 currently 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 second Initial Decision Paper sets out the Commission's current view on the prospects for prices in the next regulatory period.

Key messages

It has become clear that Scottish Water will have to invest more in maintaining its assets, improving levels of service to customers and meeting more demanding water quality and environmental standards. The Scottish Government has indicated that less borrowing will be available in the next regulatory control period.

Given that the enhancement investment programme is unlikely to decline materially (and will be an on-going annual commitment), it could be prudent to borrow less. Borrowing more may reduce prices in the short run but such an approach increases prices for future generations.

The combination of higher levels of investment and reduced borrowing could put material upward pressure on prices.

There is scope to reduce this pressure through managing the transition between the current regulatory control period and the next. The Ready Reckoner that we published in Initial Decision Paper 1 will allow the Customer Forum and other stakeholders to understand the implications of different transition choices.

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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Introduction

In our methodology for the Strategic Review of Charges 2021-27 we explained that Scottish Water is likely to have to invest more and may have access to less borrowing. This Decision Paper provides our initial assessment of how these two factors could influence prices in the next regulatory control period. It also discusses steps that could be taken to mitigate this impact.

We believe an early indication of the reasonable range for prices in the next regulatory control period is important if we are to build trust with customers and engage them in the process.

The Customer Forum can request more detailed price scenarios, should it find these helpful.

Future challenges

In Initial Decision Paper 1, we set out the key factors that determine prices. The two factors that have the greatest influence on customers' charges are the availability of borrowing and the level of capital investment. In the next regulatory control period, it appears likely that these factors will place an upward pressure on prices:

Lower borrowing

In its Commissioning letter for the Strategic Review of Charges 2021-27[2], the Scottish Government has indicated that the level of borrowing that it will make available will be lower than in previous regulatory control periods.

Higher levels of investment

Scottish Water will likely have to invest more in the next regulatory control period for several reasons. These include:

- the need to ensure service and risk levels are maintained over the long-term;
- further enhancement to drinking water quality and environmental performance;
- addressing emerging risks in areas such as flooding and network resilience;
- achieving compliance with UN Sustainable Development Goals in rural communities;
- higher customer expectations; and
- addressing climate change, carbon reduction and developing the circular economy.

Uncertainty also characterises some investment areas; for example, we do not yet know what investment may be required when the existing PFI contracts expire at the large wastewater treatment sites.

Future Decision Papers will explain any new information that becomes available.

Implications for charges

At the time of the last Strategic Review of Charges, we explained that higher borrowing would be required in the next regulatory control period if price increases were to be held below the level of inflation. The extent of the increase in the required level of capital expenditure was not expected at the time of The Strategic Review of Charges 2015-21. However, the upward pressure on charges resulting from an increase in investment is substantially eased because Scottish Water has successfully reduced its costs more significantly than was expected.

At this stage, we can set out initial broad ranges for the inputs to the Strategic Review of Charges 2021-27. Table 1 sets out the price implications if the Strategic Review of Charges 2015-21 runs its currently planned course. Table 2 sets out the price implications if the increase in charges is smoothed over the final two years of the current and the whole of the next regulator control period.

Initial Decision Paper 4 identifies an initial range for capital investment during the next regulatory control period of between £3.4 Billion and £3.8 Billion in 2012-13 prices.[3]

The Scottish Government allowed for borrowing in the current regulatory control period of £120 million each year. It seems unlikely that the Scottish Government will make more than £100 million a year available in the next regulatory control period, and possibly less. As outlined in Initial Decision Paper 1, we have used a base case of £80 million annually in our modelling.

2 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.

3 We use 'real' (before any adjustment for inflation) to facilitate our checking of the challenge represented by the allowed for capital expenditure programme.

Initial Decision Paper 2:

Prospects for prices

Initial Ranges

The prospects for prices set out in Tables 1 and 2 illustrate the different combinations of annual charge increases and levels of borrowing that are consistent with delivering an investment programme in the middle of a £3.4 to £3.8 Billion range (in 2012-13 prices) during the next regulatory control period.

Table 1 assumes that the increases in charges and the delivery of investment are phased only over the whole of the next regulatory control period. Under this scenario, the current Strategic Review of Charges would run its currently planned course. This implies price increases[4] of about 1.2% nominal in both 2019-20 and 2020-21

Table 2 assumes that the increases in charges and the delivery of investment are phased as evenly as possible over the last two years of the current and the whole of the next regulatory control period.

The green boxes represent possible combinations of price increases and borrowing that should allow Scottish Water to manage its finances appropriately and have a reasonable cash balance (around £50 million) at the end of the regulatory control period.

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

We have coloured the upper left black. These combinations are not possible. Scottish Water would have insufficient cash available to deliver the objectives of the Scottish Government.

We have coloured the lower right red. In our current view, these combinations would likely result in Scottish Water having access to too much cash and, consequently, not facing a hard budget constraint. As we explain in our methodology, it would be in the customer interest to ensure that Scottish Water faces a hard budget constraint.

This initial assessment shows that it will be possible, albeit challenging, to ensure that Scottish Water is funded sustainably. The potential demand for expenditure on improving resilience and the increased level of capital maintenance expenditure required explain the importance that the Commission attaches to innovation and maintaining the trust of customers, communities and other stakeholders. It will be particularly important that the Scottish Government, Scottish Water, the Customer Forum and other stakeholders take a long-term view. We owe it to current and future customers to address resilience and maintain the condition of assets for the long term. Taking a long-term view should not, however, mean that we do not begin to face up to these future challenges.

4 Depending on inflation outturns.

Table 1: Adjustment over the 6-year period 2021-27

	Annual price increase in 2021-27 (% nominal)										
Annual net new borrowing (£m)	2.5	2.6	2.7	2.8	2.9	3.0	3.1	3.2	3.3	3.4	3.5
40											
50											
60											
70											
80											
90											
100											

Table 2. Adjustment over the 8-year period 2019-2027

	Annual price increase in 2019-27 (% nominal)								
Annual net new borrowing (£m)	2.0	2.1	2.2	2.3	2.4	2.5	2.6	2.7	2.8
40									
50									
60									
70									
80									
90									
100									