

2

Assumptions on macroeconomic inputs and customer base growth

Introduction

This is the second in a series of 2018 Decision Papers that the Water Industry Commission will publish for the Strategic Review of Charges 2021-27. The Commission published thirteen Initial Decision Papers during 2017. The Commission will issue a series of further Decision Papers throughout 2018. These papers will update customers and stakeholders on the Commission's latest views and decisions for the Strategic Review of Charges 2021-27.

The 2018 Decision Papers 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; and
- The potential for Scottish Water to engage even more effectively with its customers.

The clarity of the governance framework for the water industry in Scotland is a significant strength. The role of the Scottish Government as policy maker, owner and banker is well defined and recognised. The objectives and principles of charging set the boundaries for the Strategic Review of Charges. As such, discussion about approaches to asset replacement, 'planning and prioritisation' of investment and compliance with European Union Directives takes place within the policy for the industry set out by the Scottish Ministers.

The Commission has adopted the principles of Ethical Based Regulation and intends to conduct a transparent and collaborative price review, taking account of all the evidence available to it in coming to the views set out in these Decision Papers. The final section of this paper sets out the framework for the key performance indicators that we will use to oversee the delivery of the changes to the regulatory framework.

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

This second 2018 Decision Paper sets out the Commission's views on the appropriate macroeconomic inputs to use in a Strategic Plan. It also sets out the Commission's views on the likely growth in the customer base over the regulatory control period.

2

Assumptions on macroeconomic inputs and customer base growth

The Commission's expectations

In our methodology for the Strategic Review of Charges 2021-27, the Commission set out its expectations for future proofing the water industry for customers. Scottish Water should:

1. Develop a clear strategy, maximise the opportunities available to it and provide clear evidence for its approach. Stakeholders will expect to be able to scrutinise the evidence provided.
2. Adopt behaviours that build trust and make progress in instilling pride among its customers and within the communities that it serves.
3. Ensure its asset management allows it to evidence the resources that it will need to improve its performance. Develop the asset information, which will underpin effective, efficient and timely replacement of its assets.
4. Improve its efficiency and, where appropriate, take advantage of innovation to ensure that prices are kept as low as is consistent with a sustainable industry for future generations.
5. Work collaboratively and constructively with regulators and other stakeholders to identify and implement the most effective and efficient approaches.
6. Improve the transparency and frequency of its reporting on performance.

The Commission considers that there are three key building blocks of this Strategic Review of Charges:

- *Evidencing the asset replacement challenge and developing an appropriate, efficient and effective response.* The Commission is working closely with Scottish Water and other stakeholders to establish an approach to long term asset replacement. It expects Scottish Water to develop a common understanding amongst its stakeholders of the resources that it will require in order than an appropriate transition to a sustainable level of annual investment can be put in place. Such a transition should be fair to both current and future generations. The Commission will set out its latest thinking on this issue in 2018 Decision Paper 5.
- *The introduction of a rigorous investment planning and prioritisation process:* Scottish Water will set out succinct, yet comprehensive investment appraisals that will allow stakeholders to provide an informed view on Scottish Water's proposals. Such appraisals should cover the impacts on, and views of, customers and communities. The Commission sets out its initial views in 2018 Decision Paper 3.
- *The process for evidencing financial, service level and water and environmental compliance in the coming regulatory period and beyond.* The Commission will set out its initial thinking on monitoring performance in 2018 Decision Paper 6.

2

Assumptions on macroeconomic inputs and customer base growth

Overview

Initial Decision Paper 6 set out the Commission's early thinking on inflation and appropriate interest rate assumptions for the Strategic Review of Charges 2021-27. The Commission noted that, while the rate of inflation may be relatively volatile over the next several years, it considered that a base case assumption of 2% for CPI – consistent with the Bank of England target – was reasonable. The Commission noted the historic lows for current interest rates and encouraged Scottish Water to take advantage of this situation and lock in these low rates for as long as possible.

The Commission is keeping its macroeconomic assumptions under review. It will take account of the latest views of the Bank of England, the Scottish Fiscal Commission, the Office for Budget Responsibility and City economists.

The Commission also continues to monitor changes in the household and non-household customer base. Such changes impact the revenue that Scottish Water receives from its customers. The Commission notes that growth in new connections remains broadly consistent with historic trends.

Stakeholders agree that our current proposed assumptions seem to be broadly reasonable.

The Commission remains alert to the impact of changes in the wider economy on our assumptions. Issues such as Brexit and the UK and Scottish Government's initiative to encourage house-building could impact these assumptions. At this stage, the Commission is not minded to change any of the assumptions outlined in Initial Decision Paper 6.

We have captured our current views in the following bullet points.

2

Assumptions on macroeconomic inputs and customer base growth

The Commission's thinking as it began the Strategic Review of Charges 2021-27...

- The Commission recognises the importance of keeping its macroeconomic and customer and connection growth assumptions under review.
- The Bank of England continues to target 2% inflation and appears to be very confident that it will achieve its target before the start of the next regulatory period.
- Public sector interest rates are currently negative in real terms and seem likely to remain at historically low levels for the foreseeable future.
- The Commission considers that it is in customers' and communities' interest that Scottish Water borrows for the longest term available.
- The Commission planned to use base case assumptions of 2% for cost inflation and 3% for interest rates (inflation plus 100 basis points).
- The Commission's analysis of the prospects for household growth in band D equivalents suggests that 0.9% year-on-year seems reasonable. The Commission has reviewed growth over both ten and twenty year time frames.
- Investment to support growth will be covered by the investment planning and prioritisation process.

The Commission's joint working with stakeholders has allowed our thinking to advance both more quickly and more productively...

- The Commission continues to review:
 - the minutes of the Monetary Policy Committee meetings of the Bank of England;
 - the forecasts of the Scottish Fiscal Commission;
 - the conclusions of the Office for Budget Responsibility; and
 - the views of City economists.
- The Commission has not identified any compelling reason to change its base case assumptions for inflation and for interest rates.
- The Commission continues to see growth in new connections consistent with historical trends. As such, it is not minded to change its assumptions for household growth.
- The Commission continues to monitor the non-household market to establish whether its forecast of the chargeable base remains reasonable.

2

Assumptions on macroeconomic inputs and customer base growth

The Commission is very pleased that Scottish Water and our stakeholders have engaged so regularly...

- The Commission has discussed its macroeconomic assumptions with its stakeholders.
- Some stakeholders commented that currently observed inflation is running higher than 2%.
- Others pointed out that public sector nominal interest rates are running well below 3% and are actually negative in real terms.
- Overall, however, stakeholders agreed that the macroeconomic and growth assumptions set out in the corresponding Initial Decision Papers appeared to be reasonable for the 2021-27 regulatory control period.
- They did not suggest that the Commission makes any changes.

As the Commission is at an early stage of the Strategic Review of Charges, it may still have to change its macroeconomic and growth assumptions...

- A major change in inflation or economic growth could impact nominal and real interest rates. Such a change would require the Commission to review:
 - its base case assumption for inflation;
 - its base case assumption for the interest rate that Scottish Water might expect;
 - its view on whether Scottish Water should opt for the longest borrowing term on offer;
 - growth in new household connections;
 - non-household customer numbers and volumes; and
 - its thinking on the price profile.
- There is a possibility that the Brexit process could materially impact the UK economy.
- The Commission is watching closely to see whether connection growth rates might increase as a result of the UK and Scottish Governments' initiatives to encourage housebuilding.

2

Assumptions on macroeconomic inputs and customer base growth

The Strategic Review of Charges process is at an early stage. The principal next steps include...

- The Commission sees no obvious reason at this stage to change any of the macroeconomic and growth assumptions included in its Initial Decision Papers.
- However, it will continue to review all the available evidence both with regard to the economy, outturn revenue and the potential growth in new connections.
- The Commission recognises that there are several potential uncertainties over the next 12 to 18 months that could require it to adjust its macroeconomic and growth assumptions in the Final Decision Papers.

2

Assumptions on macroeconomic inputs and customer base growth

Timetable for 2018 Decision Papers

The Commission sets out its current timetable for the publication of its 2018 Decision Papers in the following table.

2018 Decision Paper	Topic	Publication date
1	Scottish Water's Strategic Projections: A summary of our current thinking	25 July 2018
2	Assumptions on macroeconomic inputs and customer base growth	25 July 2018
3	Investment planning and prioritisation	25 July 2018
4	Meeting long-term investment needs	26 September 2018
5	Capital Maintenance	26 September 2018
6	Performance monitoring	21 November 2018
7	Financial tramlines	21 November 2018
8	Prospects for prices	21 November 2018

2

Assumptions on macroeconomic inputs and customer base growth

Regulatory framework: Key Performance Indicators

Ethical Based Regulation requires a defined framework in which a regulated company is expected to operate. It offers clear benefits to a regulated company that meets and exceeds the expectations that underpin the framework. It envisions a more collaborative approach – not necessarily always working jointly on issues – that will take more informed and better evidenced decisions and build the trust and confidence of customers and communities. The Commission set out its expectations of such a ‘paradigm shift’ in its methodology for the current Strategic Review of Charges.

The Commission’s framework for economic regulation seeks to ensure improved and sustainable outcomes for customers and communities. If it is working effectively, Scottish Water should be demonstrably making progress towards such improved outcomes.

The Commission is developing key performance indicators for monitoring, and reporting on, the revised framework for economic regulation. These indicators should apply during the current Strategic Review of Charges and in future regulatory control periods. They test whether the framework for economic regulation¹ is meeting the expectations of stakeholders and that we are making appropriate progress. Stakeholders are well positioned to gauge whether the framework is successful in allowing the industry to meet its longer-term challenges.

The performance indicators include a set of quantitative measures that should be linked to key delivery milestones within Scottish Water’s work plans for the Strategic Review Process and for the 2021-27 regulatory control period. There are also a range of qualitative assessments that all stakeholders should address regularly. The aim of these regular assessments is to ensure that there is a useful common understanding of whether the regulatory framework is working for customers and communities. Doubtless, such assessments may also identify areas for improvement.

The Commission proposes to carry out an independent qualitative survey of all stakeholders throughout the period of the implementation of the new regulatory framework. The Commission will work jointly with OECD and stakeholders to define how best to take this process forward. After the Strategic Review of Charges, the Commission would seek to agree with the stakeholders how this regular qualitative survey is maintained and, when appropriate, enhanced. The views of customers and communities will be of particular importance in this regard.

The framework of the key performance indicators set out in the chart on page 9 reflects six key building blocks outlined in the methodology. They are centered around, and dependent upon, Scottish Water taking full ownership of its strategy.

The Commission considers that the answers to these questions will provide a useful and continuing perspective on the performance of the economic regulatory framework. It looks forward to discussing with stakeholders the most appropriate way to measure the quantitative assessments included.

¹ The Commission’s expectations are set out in its methodology document, ‘*Innovation and Collaboration*’.

2

Assumptions on macroeconomic inputs and customer base growth

The Commission also recognises that the qualitative tests may be supported by some additional (and more detailed) questions. For example, it may be useful to track how stakeholders' expectations of the regulatory framework are changing at the same time as stakeholders' satisfaction with the outcomes of this framework are assessed. The Commission again looks forward to working with stakeholders to define the detail that underpins the high level qualitative assessments included in the chart.

Chart 1 – Framework for key performance indicators

