

Initial Decision Paper 6:

Macroeconomic assumptions

This is the sixth 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 review¹, 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, agreed with the Customer Forum, and consistent with the Commission's Final Decision Papers as its Draft Determination.

This sixth Initial Decision Paper sets out the Commission's current view on inflation and financing costs.

Key messages

It is notoriously difficult to predict inflation. Indeed, the Bank of England sets a range around its expectations of inflation, acknowledging that it is much easier to establish trends than to predict point estimates. Overall, the Bank of England is charged with setting an interest rate policy consistent with maintaining CPI inflation of 2%. As such, whilst the Commission recognises that the rate of inflation may be quite volatile over the next several years, we believe a base case assumption of 2% is reasonable. The Commission considers that Scottish Water should use this base case assumption in its estimates of futures revenues and costs.

If Scottish Water and its customers agree to set the actual charges that customers will pay, this transfers inflation risk on costs to Scottish Water in the short to medium term. However, it is important to recognise that customers ultimately bear the risk of inflation as Scottish Water needs to be reasonably funded to meet its obligations.

Interest rates are at historic lows in nominal terms. At the current time, they are negative in real terms. The yield curve² is unusually flat and, as such, it is possible to lock in historically cheap debt for the very long-term.

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

² A graph of the interest rates that apply to fixed term borrowing of the full range of maturities – from the very short term to the very long term.

Under public expenditure rules, only incremental changes in borrowing are counted as public expenditure. Since Scottish Water immediately reborrows the proceeds of loans that it repays to the Scottish Government³, this reborrowing does not impact public expenditure targets. This means that Scottish Water does not face any refinancing risk. Given the absence of a refinancing risk, Scottish Water and its customers may benefit from any borrowing being for the longest term available. At the current time, the Scottish Government offers a 50-year term.

One way in which Scottish Water could be encouraged to take advantage of these historic low rates for ultralong-term debt would be for customers to continue to agree to meet the costs of debt even if interest rates were to fall further.

Introduction

In the first Initial Decision Paper – “What impacts prices?”⁴ – the Commission explained that there are nine key inputs that can materially affect Scottish Water’s charges. Two of these inputs – inflation and financing costs – are determined by the wider macroeconomic environment and are outside the control of Scottish Water. Nonetheless, there are steps that Scottish Water could take that would ensure that it is efficiently financed for the very long-term. This will help provide protection for customers over the long-term.

The first Initial Decision Paper provided a Ready Reckoner. Customers and other stakeholders can use this Ready Reckoner to estimate the impact of changes in inflation and financing costs on prices. This Initial Decision Paper sets out the Commission’s initial thoughts on the inflation and interest rates that should be used in the Strategic Review of Charges 2021-27.

In Initial Decision Paper 3 – “The role of the financial tramlines”⁵ – the Commission explained the ‘tramlines’ approach, which ensures that Scottish Water is sustainably funded over the long-term. The ‘tramlines’ approach would take account of any benefits or detriment that arises as a result of actual inflation being different to that assumed in setting prices⁶. Customers and stakeholders should have confidence that, even if the agreed assumptions for the rate of inflation and/or interest rates prove to be materially different from the actual rates reported by the Office for National Statistics, the tramlines will ensure that Scottish Water remains sustainably funded and customers will get value for money. This is because the tramlines provide transparency of performance throughout the regulatory period, taking account of the actual out-turn on inflation and interest rates.

Inflation

Professor Stephen Littlechild designed price cap regulation and coined the term ‘RPI-X’. The idea was that while prices in the economy would increase (at that time measured by the Retail Price Index, RPI), the regulated company should be expected to improve its efficiency by a specified factor (X).

Most regulators continue to set prices relative to the RPI – although the UK Government’s preferred measure of inflation has now changed to the Consumer Price Index (CPI). Many regulated companies have issued substantial amounts of debt that is index-linked. Until very recently, all index linked debt was tied to RPI. It is therefore perhaps not surprising that regulators have been slow to switch to a CPI based price cap.

The Office for National Statistics does not now consider the RPI to be a suitable inflation measure.

³ Scottish Water only repays loans at the end of the agreed borrowing period.

⁴ Published on 21 June 2017 and available on the Commission’s website.

⁵ Published on 21 June 2017 and available on the Commission’s website.

⁶ We would expect Scottish Water, when reporting its progress in reducing its costs, to identify factors outside management control and adjust their performance accordingly.

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At the Strategic Review of Charges 2015-21, Scottish Water and the Customer Forum agreed that the RPI was no longer a suitable price measure for customers and should be replaced by the Consumer Price Index (CPI). They agreed price caps that were tied to the CPI. The Commission agreed with this approach but retained the use of the RPI within the calculation of the Scottish Water costs that it allowed for.

For the Strategic Review of Charges 2021-27, the Commission considers that the CPI should also now be applied to the costs that Scottish Water incurs. Scottish Water does not have any index-linked debt and it seems inappropriate to retain any link to a measure of inflation that the Office for National Statistics considers to be obsolete.

As noted earlier, point estimates of inflation tend to be quite inaccurate. It is much easier to identify trends. Even when analysts know the rate of inflation for the first 9 or 10 months of the year, their forecasts for the full year are often materially incorrect. As such the Commission believes that Scottish Water's business plan, and the financial models that underpin the Strategic Review of Charges 2021-27, should use the Bank of England target rate of 2% for the CPI.

Scottish Water may consider that cost pressures in its business are not well reflected in the CPI. In such a case, Scottish Water could provide evidence of how it was disadvantaged. Any such disadvantage should be demonstrated after taking full account of the benefits of their costs being linked to CPI. The Commission's Final Decision Paper on macro-economic variables would comment on Scottish Water's evidence.

The Commission recognises that actual inflation during the regulatory control period could be higher or lower than the Bank of England target rate. Such variances would impact Scottish Water's cashflow. However, we are confident that we can effectively monitor and address any such variances using the financial tramlines. Our third Initial Decision Paper explains how the Commission can track Scottish Water's financial position.

Financing costs

Scottish Water has a large amount of outstanding debt – some £3.4 Billion at the end of the 2016-17 financial year. Currently, around £46 of the average household bill of £357 goes to service interest payments on debt. Scottish Water does not repay debt early. It refinances all existing debt at maturity. This refinancing exercise does not impact on the new borrowing available to Scottish Water. Its average interest rate has been falling both because the refinanced debt has been cheaper than the debt which has matured and the new debt that it takes on is lower than its current average. Should interest rates start to trend upwards, customers could see the proportion of their household bill that goes to service interest payments increase.

Scottish Water is, theoretically, free to borrow at the cheapest rate available – irrespective of the lender – up to the limits specified by the Scottish Ministers. In practice, however, even the cheapest commercial loans (such as EIB⁷ financing) are more expensive than borrowing from the Scottish Government.

Scottish Government loans have a fixed nominal interest rate for the duration of the loan. There are no index-linked loans available. The interest rate is generally equal to the yield on a UK Gilt of similar maturity plus a small margin of around 0.25%. Interest rates are currently negative in real terms and the yield curve is relatively very flat by historical standards. As such, the Commission considers that customers may be best served if Scottish Water takes advantage of these very low interest rates and locks in these rates for the longest maturities available (50 years) when refinancing existing debt at maturity or adopting new debt.

We recognise that, in the short term, there may be a very marginal benefit – from slightly lower interest rates – for customers by taking on borrowing with a shorter duration; but history suggests that nominal interest rates are unlikely to remain so low over the next few decades. As such, Scottish Water's customers may be well served by borrowing for the very long-term. In our view, Scottish Water should carefully consider how it borrows when it develops its strategic projections and business plan.

⁷ The European Investment Bank (EIB) is the European Union's bank and the world's largest multilateral borrower and lender. It provides finance and expertise for sustainable investment projects that contribute to EU policy objectives.