Borrowing, risks and charges in the water industry: a rejoinder to the Cuthberts

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In their article* in the June 2006 issue of this Commentary, Jim and Margaret Cuthbert address a number of questions to the Water Industry Commission for Scotland, the industry regulator. These questions reflect the authors' concerns about some regulatory procedures and decisions, concerns that they have expressed earlier elsewhere. The Cuthberts' criticisms can be summarised in the proposition that Scottish Water should be allowed to borrow more money, and thereby be able to lower its current charges to customers.

Before addressing this question, we at the Commission should like to acknowledge our appreciation of the fact that by raising such issues, the authors have increased the level of awareness about the water industry amongst politicians, the media and the public. Generally speaking, water is an industry whose importance in the economy is frequently overlooked. Its operations are taken for granted. When a householder turns on the tap, s/he expects to find fresh water of a good drinking quality coming out, and when the toilet is flushed a similarly automatic performance is expected to make the wastewater disappear without damaging the environment.

So far as price is concerned, most households probably do not know the amounts that they pay annually for water and waste water services, which are combined with their council tax bill. And there are not many businesses for whom water is one of their major costs. Therefore, although everyone is affected by the operations of the water industry, very few take an interest unless something goes wrong that affects them directly, like their water supply being disrupted or the sewerage system malfunctioning.

Even fewer know about the continuing programme of capital expenditure to maintain, upgrade and renew pipelines, sewage works and water treatment plants, although the associated road works are annoyingly familiar. Over the next four years this capital expenditure in Scotland will amount to more than £2.5 bn[1]. In future years it is likely to remain at high levels, or even increase still further in response to rising standards. Measured by size of assets, the industry is easily the largest in the country, with a replacement value of assets of around £28 bn. If all the fresh water pipes in Scotland were laid end to end, they would stretch one-a-half times round the world. By any standards this is a major industry.

The big issue

Since Scottish Water, the sole supplier, is publicly owned, there are no shareholders' funds, so these very large and continuing levels of capital expenditure can be funded from only two sources. Either water charges can be increased, or the level of borrowing can be increased. Of course, if the level of borrowing is increased, this just means that charges must go up in the future to make the deferred repayments of capital, plus interest on the borrowing. Moreover, if the Executive's overall level of borrowing is constrained, then an increased level of borrowing by Scottish Water can only be accommodated by making cuts in other areas such as education or health.

How much should charges go up this year, and how much in future years, is a matter of judgment, a judgment which it is the responsibility of the Commission to make within the parameters laid down by Ministers in their Principles of Charging. Every four years it has to make a decision about the level at which water charges should be set for the next regulatory period. This is called the Determination of Charges. The final version of the most recent Determination was published on November 30th 2005. The new price limits came into effect on April 1st this year and cover the four year period until March 31st 2010. In this Determination we decided that charges for household water and waste water (i.e. sewage) services should rise by 0.5 per cent below the annual rate of inflation measured by the RPI. For businesses the rate of increase is even smaller, 1.5 per cent per annum below the rate of inflation. In other words, for both households and other users water charges will fall in real terms in each of the next four years. This means that by the year 2010 the average household water bill in Scotland should be lower than the average bill in England and Wales. And this is despite a programme of capital expenditure larger than ever before and, in proportion to the population served, larger than any current programme in England and Wales. It is a challenge for Scottish Water to achieve these targets, but we are confident that, in the light of their recent good performance, they can do it. Should they fail, the cost of underperformance will fall on Scottish Water's owner, the Scottish Executive, and not on customers.

These numbers were not just plucked out of thin air. They were the result of three years' hard work by the then Commissioner and his staff. Extensive consultation took place at every stage. Right at the start, no fewer than six volumes were published (see www.watercommission.co.uk) setting out in detail the methods and procedures we proposed to follow, and the reasons why. Comments on our methodology were invited and received during a three-month period of consultation. In making his calculation, the Commissioner was guided not only by the Ministerial objectives for the industry, but also by the Principles of Charging that were issued to him by Ministers. Of these Principles, the two most relevant to the present discussion were that (1) if possible, prices should not fluctuate too much from one regulatory period to another, and (2) borrowing by Scottish Water should be kept at levels that would not imperil the financial sustainability of the company.

Ministers also specified in detail the outcomes they wished to see delivered by the 2006-2010 capital expenditure programme. To pay for these projects, our Determination calculated that, in addition to the revenue they will get from the increased charges Scottish Water will have to borrow some £782 million over the next four years to cover their total outgoings. Had we allowed more borrowing, then charges in the present regulatory period, 2006-2010, could have been set to increase at a rate even slower than they are. But of course, they would then have had to rise even faster than otherwise in the period 2010-2014, as the Cuthberts recognise[2]. The implications for prices of greater borrowing were calculated in our Draft Determination, (Volume 7, Chapter 4, Table 4.11) published in June 2005.

It is the nub of the argument that more should have been allowed to be borrowed in the present regulatory period, (as well as more in earlier periods). So who is right? The answer is of course that there is no right answer: in any company how much expenditure should be funded by current revenue and how much by borrowing is a matter of judgment. There is no clear cut rule, as the Cuthberts seem to imply. Nor can there be, since a lender will want to take into account the financial strength of the borrower before deciding how much to lend. The Commission has set out at length and in great detail not only how it arrived at the answers embodied in its Final Determination, but also the reasons why it adopted the procedures it did. Nothing that we have read or heard since then has persuaded us that there is any reason to change our minds.

Technical questions

In their paper, the Cuthberts raise a number of technical questions to which we now turn:

1. Although they said that "the primary subject of their paper" was "to develop more fully our thoughts on the differences in risk for public and private bodies" (para 1.2), they do not do this. That is a great pity because it is a topic worthy of discussion, and in an earlier exchange they had offered to measure risk in a publicly owned water business. Instead, they complain that the Commission should not have used unadjusted Ofwat financial ratios in its calculations, "given the different financing options open to Scottish Water". They seem unaware that these financial ratios are cash flow ratios, not accounting ratios. And that Ofwat applies its financial ratios equally to Welsh Water, although that company has only a nominal equity layer, and can therefore only be financed by a mixture of debt and revenue.

2. Their main assertion that too much capital expenditure is being funded out of revenue appears to be based on a general proposition that net new capital formation should always be wholly funded from borrowing. This is not a proposition that would command universal support. Few householders, for example, would think it prudent in all circumstances to borrow 100 per cent of the cost of their new home. What proportion should be borrowed very much depends on an assessment of the risks inherent in the particular situation. It is the Commission's judgment that Scottish Water faces significant business risks, and that these risks should be taken into account in setting the level of borrowing.

The Cuthberts' view seems to be that Scottish Water should borrow whatever monies are available from the Executive. The Commission believe, on the other hand, that using financial ratios provides a more rational way of determining how much should be funded from borrowing and how much from revenue. The majority of the Finance Committee of the Scottish Parliament has accepted that it should be the Commission's responsibility to decide on "a prudent level of borrowing within the expenditure limits, not to agree to a level of borrowing consistent with the public expenditure limits", (2nd Report 2004, para 109.)

3. The Cuthberts appear to take the view that either (a) investment in the public sector is risk-free, or (b) that the water industry is a risk-free area. On the latter point it may be recalled that the drought of 1995 cost the shareholders of Yorkshire Water some £240 million, while only a few weeks ago Thames Water was obliged to agree to invest an additional £150 million of their shareholders' funds because their leakage experience had been worse than anticipated. A further, and still more costly, deterioration of their underground assets in future cannot be ruled out. At the same time Ofwat announced that Thames would have to pay a fine of an as yet undisclosed amount for customer service failures.

Scottish Water would seem to face two generic types of risk:

(a) delivery risk – the risk that it may use up all its available capital without having delivered all the scheduled outcomes;

(b) financial risk – the risk that it may achieve all the outcomes, but exceed its budget. The 'overhang' of uncompleted capital projects from the 2002-2006 regulatory period already amounts to an estimated £274 million, and may turn out to be larger. It should be emphasised that any overspends in the water industry in

Scotland will come straight out of the pockets of the Scottish, not the UK, taxpayer, since there is no corresponding item in the Westminster budget.

4. The authors also complain that the pre-tax (accounting) profits for Scottish Water are projected to be over £800 million over the period 2006-10, and ask “What can possibly justify such high levels of retained profit?” The short answer is the need to contribute to the very high levels of capital expenditure, of the order of £2.5 billion over the same period that are likely to continue into the foreseeable future.

If customers, through the political process, say that they want a large investment programme as well as financial sustainability that implies that they want large profits to be made by the supplier. In England, where the water companies also make large profits, there may be room for argument about the appropriate division of these profits between re-investment and distribution to shareholders. In Scotland, where the only shareholder is the Executive and all profits are re-invested, no such issue arises.

5. Finally, they appear to suggest that in Scotland water charges should be set artificially low to attract water-intensive industries, (para 4.3). To do this would be likely to invite the disapproval of both the environmental and the competition authorities in Europe. Such disapproval would, in our view, be well-founded. If Scotland does indeed have a comparative advantage in water-using industries, and it may, then that would best be exploited by ensuring that the Scottish water industry is efficient, and that its charges are truly cost-reflective. We have seen too many examples in the past of industries attracted to locate in Scotland by the offer of short term subsidies. When the subsidies are withdrawn, the factories close and the jobs disappear.

Conclusions

The plans for the water industry in Scotland for the next four years, as set out in the Commission’s final Determination published on November 30th 2005, have been accepted by Scottish Water, and approved by the Executive and by Parliament. Work will soon begin on plans for the regulatory period 2010-2014. In June 2007, the Commission will publish the procedures it proposes to adopt to arrive at its next Determination. At that point, comments and suggestions for improvement in those procedures will be invited. We very much hope that everyone who is interested in the future of the water industry in Scotland, including the Cuthberts, will then make their views known.

* Jim Cuthbert and Margaret Cuthbert, “Risk and Profit: Unanswered Questions about the Strategic Review of Water Charges 2006-10”, Quarterly Economic Commentary, The Fraser of Allander Institute, University of Strathclyde, June 2006

Endnotes

[1]In current prices. In constant 2003/04 prices, the figure is £2.15 bn)

[2]Cuthbert and Cuthbert, section 3.7.