Note 22 for the Customer Forum

water industry commission FOR SCOTLAND

Scottish Water's draft business plan: Growth

Scottish Water published its draft business plan on 30 October 2013. This note is one of a series that the Commission is publishing to provide an objective assessment of the plan and to facilitate discussions between the Customer Forum, Scottish Water and other relevant stakeholders.

The Commission is aware that Scottish Water and the Customer Forum have been in regular and detailed discussion over many months. In drafting these notes the Commission has been briefed by the Customer Forum on its emerging thinking having seen the draft business plan as it was being developed. As such the notes contain advice on areas that the Customer Forum has identified as being important to it.

The notes highlight the strengths of the business plan and areas where the Customer Forum may wish to focus its discussions with the company. Although each note focuses on specific areas of the plan that are material to customers, final decisions should be taken 'in the round', reflecting the overall package of price and service levels agreed between the Customer Forum and Scottish Water.

Introduction

This note presents the Commission's views on the levels of growth and associated costs included in Scottish Water's draft business plan. In our view this is an area where Scottish Water appears to have taken an overly cautious approach. It is therefore an area to which the Customer Forum may wish to pay particular attention. This note sets out the Commission's views on what might be a more appropriate estimate of likely growth, and a suggested approach to mitigate the risk of opting for higher growth rates.

In Scottish Water's business plan proposals, the impact of new customers on the network accounts for around 7% of proposed investment and provides additional income of around £17 million a year.

Overview of business plan proposals

Growth assumptions

Scottish Water assumes that the number of households paying charges will grow by 0.67% a year. As such, it is expecting to connect 99,000 new household properties over the period 2015-21.

In the non-household sector, Scottish Water highlights the risk from the steady reduction in volumes of non-household water demand since 2008, which may lead to under-recovery of costs in this area. However, the company believes that this contraction could be broadly offset by forthcoming changes in the wholesale charging arrangements, which are expected to increase the customer base.

Overall, Scottish Water would expect its revenues to remain flat in real terms over the period (ie growing by 0% per year) without any changes in the Government's policy on charging. The company recognises, however, that the proposed introduction of charges to vacant properties could be expected to increase revenue by £15 million a year from 2017-18.

Scottish Water suggests the use of a 'wholesale revenue cap' mechanism[1] for the non-household sector. This would protect household customers by ensuring that if growth is overstated, charges to non-household customers are increased to compensate. There would be no impact on household customers. Scottish Water also suggests that its proposed approach would provide a useful further incentive to licensed providers to identify properties that are not currently billed. This is because any additional income from these properties would reduce the wholesale tariffs that the licensed providers pay.

Investment and expenditure in growth

Scottish Water forecasts that it will invest £207 million over the period 2015-21 to meet additional demand for water and waste water services. Of this, £24 million will be for strategic infrastructure funded through the 'infrastructure charge', which is paid by those connecting to the network.

Table 1: Scottish Water's growth investment proposals

Programme	Forecast investment and expenditure £m (2012-13 prices)
'Reasonable cost' contributions	77.4
Treatment strategic capacity	68.4
Adoption of developer assets & non-domestic meters	23.5
Relocation of services for transport infrastructure projects	13.8
Total net investment	**183.1**
Strategic infrastructure	24.0
Total gross investment	**207.1**

Scottish Water expects 100% of new demand for water services and 63% for waste water services to be supplied from existing assets. The company is also proposing to ring-fence investments on growth and to review its proposals when it updates the capital expenditure programme planned for 2018.

Our analysis and issues arising

Growth assumptions

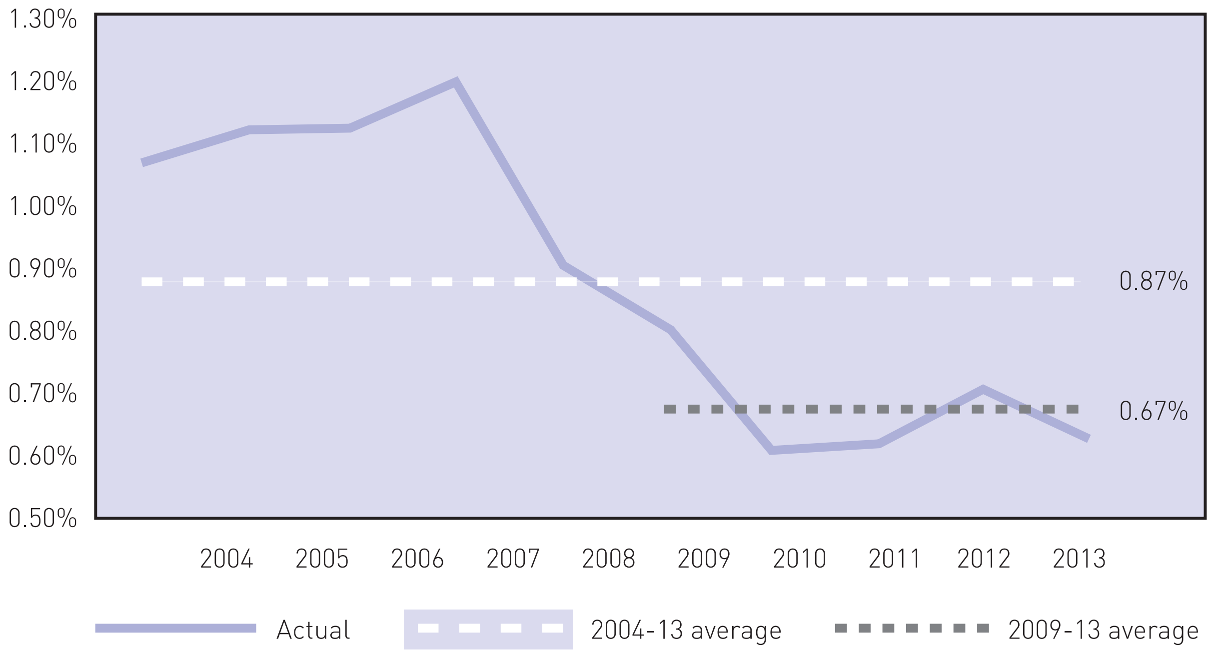
The household growth rate that Scottish Water is forecasting (of 0.67% a year) is in line with the average growth rate of Band D equivalent properties[2] over the last five years. We believe that this estimate is unduly cautious. It reflects a period when housing development has been significantly curtailed by both a relative paucity of bank finance and by the economic downturn.

[1] A wholesale revenue cap mechanism removes uncertainty from the revenues Scottish Water will earn from the non-household sector by fixing this income and adjusting the wholesale charges that the licensed providers pay. This mechanism has been employed in previous review periods.

[2] The concept of 'Band D equivalents' was developed to convert the number of households included in different tax bands, and therefore paying different bills, into a standard measure through the use of a set of weights (for example, a Band A property is weighted 6/9 relative to a Band D, while a Band H is weighted 18/9).

While we would not advocate switching back to the rate of new connections in the five years immediately preceding the banking crisis, a rate of connections around the ten-year average (or perhaps slightly higher) may be reasonable. It should be noted that new properties are, on average, allocated to higher bands; as a result the growth in 'Band D' equivalents will typically be slightly higher than the absolute number of properties connected.

Annual growth rate of water Band D equivalents (%)



As a result, for revenue purposes, we believe that it could be appropriate to assume household growth in the range of 0.8% to 1.0%. This range is consistent with the average over the last ten years. The Customer Forum should also be aware that more recent news from the housing sector has been much more positive than it has been in the past few years.

It is, of course, possible that the current perceived recovery in house building is a false dawn. In this eventuality, the review of investment in 2018 provides an appropriate point to reconsider assumptions on growth and any implications arising.

Scottish Water's forecast that there will be no change in the non-household customer base requires that the number of business customers will increase sufficiently to offset any decrease in the volume of water used by current business customers. We believe that this could be overly optimistic and, based on the historic weighted average of volumes and supply points of water and waste water over the past five years, we suggest that the Customer Forum looks to agree a decrease in the range of 0.5% to 0.75%.

Investment in growth

The Commission reviewed Scottish Water's proposal for investment and expenditure in meeting new demand for water and waste water services. Following an adjustment of £21 million to correct a miscalculation in relation to reasonable cost contributions, Scottish Water proposed a revised total for the gross investment requirement of £228 million.

Of this total, £167 million (£28 million a year) relates to reasonable cost contributions and investment in treatment strategic capacity which can be directly compared with the historic average expenditure in these areas between 2006 and 2013, as shown in Table 2.

Table 2: Historic comparison of growth investment

Expenditure on reasonable cost contributions and treatment strategic capacity (2012-13 prices)	
Average from 2006-07 to 2012-13	£39m per year
Forecast for the period 2015-2021	£28m per year

Our analysis suggests that Scottish Water's proposed expenditure in this area is lower than it has been historically. This appears consistent with the capacity in the network that has been created through leakage reduction and synergies with the ongoing capital enhancement programme. Further progress on leakage reduction in the 2015-21 period would help offset future growth expenditure requirements in future regulatory control periods.

We note that Scottish Water is forecasting that it will receive £7 million a year in infrastructure charge income from developers. Given that it is forecasting to connect 99,000 new household properties, we believe that this may underestimate the infrastructure charge income that Scottish Water will collect by around £3 to £4 million[3] a year.

We acknowledge that a higher growth rate may entail some additional investment from Scottish Water (most likely on the waste water service). Scottish Water would also face further reasonable cost contributions. However, in our view, Scottish Water could be expected to absorb these costs at least until the investment review in 2018.

The extra income from infrastructure charges along with the additional revenue from new customers may be sufficient to offset any additional investment required from Scottish Water. We also believe that there is further scope for Scottish Water to adopt innovative approaches to new connections and that this could reduce costs. We would expect to see progress in this regard over the next few years.

[3] We assume that Scottish Water will receive an average infrastructure charge payment of £630 from each of the 102,000 new connected properties (99,000 household and 3,000 non-household properties). This indicates that the company would collect £60 to £65 million in infrastructure charges over the period 2015-16 to 2020-21, about £20 million above its conservative estimate of £42 million.

Conclusion

Growth is an area where the Customer Forum should focus its attention. There is scope to increase the estimate of the level of growth in new household connections. At the same time, the proposed revenue profile expected from the non-household sector may be too optimistic.

The Forum may also wish to discuss with Scottish Water whether or not it is necessary to ring fence growth investment and expenditure given that a review of the investment required is planned for 2018 (which will provide an opportunity to adjust levels of allowed for expenditure). In our view this ring fence is not required.

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