

Initial Decision Paper 9: Growth Investment

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

This ninth Initial Decision Paper sets out the Commission's current view on investment by Scottish Water to respond to economic growth and offer connections to new customers that may previously have been served by a private supply.

Key messages

The Commission explained in its methodology why Scottish Water should set out the investment that it believes is required to meet the needs and expectations of its customers and the objectives required by the Scottish Ministers.

Scottish Water has begun to make process and administration improvements and progress other initiatives that more pro-actively facilitate new connections to its network. These are welcome. Scottish Water should continue to review the steps that it can take to be seen to be an enabler of development and not a constraint.

Of course, Scottish Water must act in the general interest of both its existing and prospective customers and the wider economy. It should, therefore, look to borrow to cover the up-front costs (initial negative cashflow) of extending its network and services. Most new connections are likely to pay back after around ten years. Over the longer term, increases in the number of connections generally reduce the level of charges that an individual customer will have to pay².

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

² The marginal cost of a new connection is generally lower than Scottish Water's current average cost of a connection.

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Improving services in very rural areas (previously served by private water supplies or septic tanks) may never be self-funding but there are good societal reasons to make progress. We expect Scottish Water to use its expertise to provide support and services to rural communities wherever practical and desired by the local community. This is consistent with UN Sustainable Development Goal 6.

Introduction

Growth investment accounts for a relatively small proportion – around 10% - of Scottish Water’s total investment but it is very important to prospective customers, the Scottish economy and to achieving a more sustainable and healthier society.

The connection of new homes and businesses requires investment to extend the network and, where necessary, expand the capacity of the collection, discharge and treatment facilities. Scottish Water also makes a contribution to the developers of new properties, in recognition of the future income stream from the customer, which helps cover the installation costs of connecting these new properties to the Scottish Water system. Where there is headroom available, the payback on these developer contributions is quite quick (typically less than 10 years). Where investment is required to increase the capacity of the wider system to meet this new demand, the payback will likely be much longer.

Households and businesses located in the most rural areas may currently have private solutions. In many cases, the users are happy with their current solution. However, if a local community wants to improve these arrangements, Scottish Water may be able to help. It is possible that it will be economic to add some of these properties to the existing network. In other cases, Scottish Water may be able to provide support to rural households and businesses both in terms of maintaining water quality and ensuring water sufficiency. Scottish Water already offers a similar support service for the owners of septic tanks.

Facilitating growth

Scottish Water has taken a number of steps to ensure that developers find it more straightforward to make the connections to Scottish Water’s network that they need. For example, Scottish Water has recently said that it will seek to provide additional capability for businesses, subject to minimising the risk of ‘stranded assets’. This reflects the excellent progress that has been made in reducing leakage. The increasing use of sustainable urban drainage systems allows for more connections to be made to the sewerage system. Scottish Water also plans to review how it charges developers more generally³.

Scottish Water is seeking to improve its detailed understanding of the extent and timing of future demand for its services. Scottish Water will likely have to continue to improve its understanding of demographic trends and the level of capacity utilisation at potentially constrained parts of the water and wastewater system. This improved understanding should allow investment to be made more strategically and more efficiently.

Any proposed changes in charging developers for new connections both to the water and waste water systems could have the potential to increase the upfront costs (negative cashflow) and the likely payback period.

At the current time, the number of new connections appears to be increasing. This reflects the level of new housebuilding activity across Scotland.

³ Inevitably, any change in developer charges would impact on the costs falling on customers.

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Financing growth

It is for Scottish Water to set out, in its Business Plan, the investment that it believes to be required to ensure that the demand for new connections is met in a timely and efficient manner. It is important that its projections on revenue growth, costs incurred, borrowing utilised and available capacity for new connections are consistent. The Commission will comment on the evidence provided by Scottish Water later in the Strategic Review process. Scottish Water will require to provide sufficient evidence that withstands scrutiny from the Customer Forum and other stakeholders.

It is, of course, very difficult to predict whether the current demand for new connections will continue. As such Scottish Water will have to strike a balance between facilitating connections and over-extending its capacity to meet demand. Scottish Water should seek to set out its approach and report regularly on progress and its available capacity. Scottish Water's reporting could be at an aggregated level for regulatory purposes, although developers would no doubt expect to be able to understand what investment requirements, if any, there may be in each water supply zone.

Investment to respond to new connections from developers will, in the long run, increase the customer base and, therefore, the revenue of Scottish Water. In most cases, there is a broad payback on the investment. It is reasonable that Scottish Water should borrow to cover the negative cashflow that it will incur in meeting the needs of developers. Where annual investment in meeting new demand is not expected to pay back, the difference between the NPV of the expected future charges and the marginal costs incurred could be met by a permanent increase in borrowing.

The payback of meeting each developer's need will, of course, vary. Scottish Water should make clear how meeting the needs of developers is impacting its business in line with the Commission's expectations set out in Initial Decision Paper 5.

Rural Water and Waste Water Supplies

Scottish Water supplies the vast majority of households in Scotland. Less than 3% of households rely on private water supply arrangements while around 7% of households have private waste water provision (typically septic tanks). Some households with private arrangements are content with their existing arrangements and meet the required standards – others can experience issues of water quality and water sufficiency, while poorly maintained septic tanks can cause environmental damage.

In recent months, the importance of ensuring satisfactory arrangements for existing private water supplies has received greater attention. The Scottish Government is engaging with industry stakeholders to ensure its responsibilities under the United Nations Sustainable Development Goal 6 are being effectively met.

Recent investment by Scottish Water shows how important it is likely to be to find innovative and tailored solutions to the needs of those households, currently served by private supplies, who suffer from water quality and sufficiency problems. There will need to be a constructive dialogue about the types of service that Scottish Water could potentially deliver and agreement as to an appropriate governance framework. It will likely be prohibitively expensive to connect some properties to the public water and waste water system.

Scottish Water's septic tank emptying service is a good example of how Scottish Water can potentially help a customer with a private water supply. This could include providing extra water in the event that there is an issue of water sufficiency or providing support if water quality is adversely impacted by weather or local land use. There may also be more that could be done to support households with private septic tanks.

Scottish Water potentially faces a significant reputational risk if it is not seen to be active in supporting those households who are not content with their current private supply arrangements. The issue of rural broadband should serve as a useful warning to the water industry in Scotland.

Scottish Water's Business Plan should set out how it intends to work with industry stakeholders to begin to address this issue.