Charging for trade effluent: a consultation

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1. Introduction

This consultation explores issues relating to the way in which Scottish Water charges customers for trade effluent services. We invite the views of customers and other stakeholders on these issues.

Responses should be sent to:

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Responses should be submitted no later than 25 September 2006.

We will publish all responses to this consultation unless respondents request otherwise.

Printed copies of this consultation are available from the address above. Electronic versions are available on our website at www.watercommission.co.uk.

2. Background

The Water Services etc. (Scotland) Act 2005 established the Water Industry Commission and gave us the power to regulate Scottish Water's trade effluent charges. Previously, Scottish Water set its trade effluent charges and customers could only appeal these to Scottish Ministers.

During the 2002-06 regulatory control period, Scottish Water operated two separate capping arrangements that limited increases in bills for trade effluent.

- A harmonisation cap: where quality and quantity parameters remained the same, the year-on-year increase was limited to 15%.

- A treatment cap: customers in locations where treatment was upgraded or provided for the first time were subject to a 100% cap. That is, charges could at most double because of new treatment.

As a result of these arrangements, some customers pay less than the published tariffs.

In our Strategic Review of Charges 2006-10, we set limits on increases in published trade effluent tariffs. These are shown in Table 2.1.

Table 2.1: Trade effluent charge caps 2006-10[1]

Charge cap	**2006-07**	**2007-08**	**2008-09**	**2009-10**
Trade effluent	RPI-1.5%	RPI-1.5%	RPI-1.5%	RPI-1.5%

Scottish Water's second draft business plan indicated that capping arrangements would end by 2008-09 and at that point all customers (except those who had separately negotiated 'special agreements' with Scottish Water) would pay the published trade effluent tariffs.

However, our analysis of Scottish Water's proposed charges scheme for 2006-07 revealed the full extent to which some customers were paying less than the published trade effluent tariffs. Our analysis showed that Scottish Water's capping arrangements had not been effective in moving customers' charges towards the published tariff levels. Some examples of the discounts[2] offered to customers include:

- a refrigeration company currently paying c. £100K that should be paying in excess of £320K;

[1] RPI: Retail Price Index.
[2] These discounts are not caused by negotiation of a separate special agreement by these customers.

- an electronics company currently paying c. £120K that should be paying in excess of £270K;
- a brewery currently paying c. £60K that should be paying almost £200K;
- a distiller currently paying c. £1K that should be paying in excess of £50K; and
- a small metals company currently paying c. £20 that should be paying in excess of £1,200.

We are concerned that the low tariffs that Scottish Water charges some customers may fall foul of:

- competition law: Scottish Water may be showing undue discrimination for or against various customer groups; and
- European State Aid rules: some of the bills that Scottish Water charges may be below cost, and, as such, could be viewed as a state subsidy.

In its charges scheme, Scottish Water proposed to continue its trade effluent capping arrangements for 2006-07. It also proposed to move all customers onto published rates in 2007-08.

Our analysis showed that this proposal would result in unacceptable single-year increases for some customers in 2007-08. This would clearly be inconsistent with the Scottish Ministers' statement of policy on charges for the 2006-10 regulatory control period, which stated:

"The Commission and SW [Scottish Water] should ensure, where a permanent increase in a given tariff is necessary, that the increase is phased over the review period unless there is a more effective means of minimising the impact of the increase."

We suggested to Scottish Water that it should amend its charges scheme proposal for 2006-07 such that all customers' bills would rise by a maximum of 0.99%. In our view, Scottish Water needed to consult on how changes in tariffs for those customers who paid much less than the published tariff should be handled.

This consultation does not affect customers who have separately negotiated a special agreement with Scottish Water. Such agreements will continue in the future. Customers who reduce the cost to Scottish Water of providing them with a service may also be eligible for special agreements.

3. Effects on customers

Information from Scottish Water indicates that there are around 1,800 trade effluent customers in Scotland. Our analysis suggests that nearly half of these customers pay reduced tariffs[3]. Table 3.1 summarises the monetary and percentage increases that would be required to move all customers to published rates

Table 3.1: Increases required so all customers pay the published rates

		Required £ increase to reach published rates						
		£0	**£0 - £200**	**£200 - £500**	**£500 - £1,000**	**£1,000 -10,000**	**Above £10,000**	**Total**
Required % increase to reach published rates	**0%**	912	-	-	-	-	-	912
	0 - 25%	-	95	47	27	56	10	235
	25 - 50%	-	40	37	19	52	14	162
	50 - 100%	-	37	31	26	58	12	164
	100 - 500%	-	48	37	36	73	26	220
	Above 500%	-	33	18	8	34	19	112
	Total	912	253	170	116	273	81	**1,805**

These discounts to some customers cost other business customers around £4 million a year. We summarise the impact of the discounts on Scottish Water's revenue in Table 3.2.

Table 3.2: Revenue from customers moving to published rates[4]

Current revenue	£21.2 million
Revenue if all pay published rates	£25.2 million
Difference	£4.1 million
Current revenue from customers paying less than published rates	£8.5 million
Revenue from these customers if moved onto published rates	£12.6 million
Difference	£4.1 million

The average customer who is currently paying below published rates would face an increase of around 50%. However, as Table 3.1 shows, there would

[3] Information in this consultation is taken from Scottish Water's 'WIC 52' submission (adjusted by removing apparently erroneous data). There is some discrepancy between this information and the Annual Return information that Scottish Water submits, however, we have used the WIC 52 as it contains more detailed information.

[4] This table excludes revenue from special agreements. Numbers do not add due to rounding.

be a wide range around this average. Some customers would experience bill increases that are considerably greater than the average.

Transition arrangements

In our view, the following issues need to be considered in moving customers onto the published tariffs:

- when phased increases should start;
- the method of charge increases; and
- how long it should take to reach published rates.

When phased increases should start

We recognise that businesses need as much advance warning of potential increases in charges as possible in order to plan their budgets.

The earliest that we could begin the transition would be 1 April 2007. Tariffs for 2007-08 are likely to be announced by January 2007. If we approved a programme of phased increases commencing in 2007-08, this would only give companies around three months' notice that charges were going to rise. This may not be sufficient for these companies to incorporate changes into their budgets.

We therefore consider that it may be more appropriate to approve a capped increase for all trade effluent bills for 2007-08 and to commence the phased increases to published tariffs in 2008-09. This would have the additional benefit that the start of the transition would coincide with the opening of the non-household market to competition. We would proceed to limit increases in bills in 2007-08 to the charge cap[5]. This would also give Scottish Water time to communicate changes in bills to customers.

The method of charge increases

In our view we also need to ensure that an equitable approach is adopted when moving customers onto the published tariff.

Scottish Water's previous system of capped annual percentage increases has not proven effective. If we continued Scottish Water's policy of capping increases at 15%, it could take more than 30 years for all customers to pay published rates. This would unfairly discriminate against other non-household customers.

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[5] As shown in Table 2.1, charge caps are 1.5% below inflation.

There are two alternative approaches that could result in a smooth transition. The first would be to calculate an individual percentage ‘cap’ for each customer who is paying less than published rates. This would be calculated using the formula shown in Figure 3.1.

Figure 3.1: Individual percentage increases

$$\text{Annual percentage increase} = \left(\frac{\text{published rates bill}}{\text{current bill}}\right)^{(1/n)} - 1$$

Where n = number of years charge increases are being phased over

The second option would be to increase each customer’s bill in equal monetary amounts each year. This would be calculated using the formula shown in Figure 3.2.

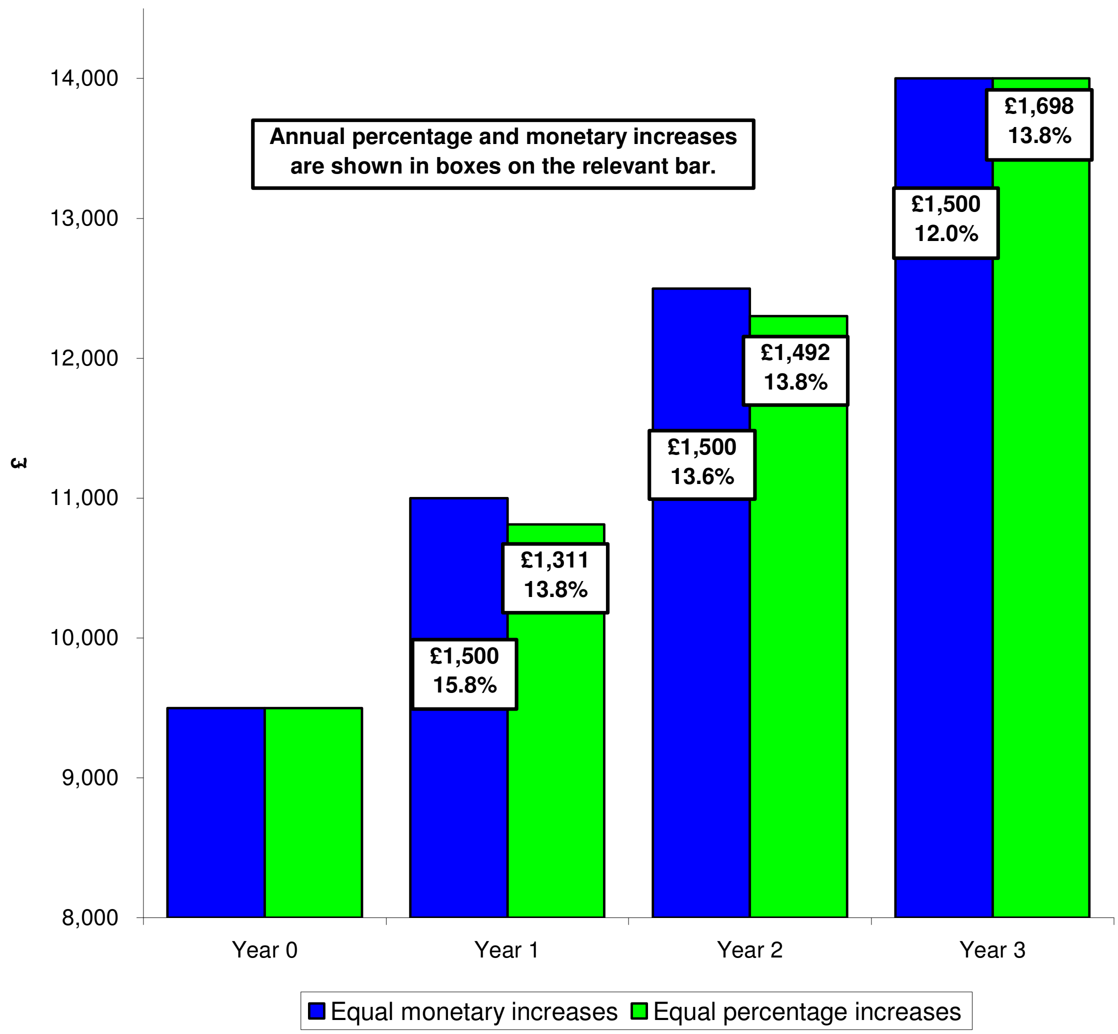
Figure 3.2: Individual monetary increases

$$\text{Annual monetary increase} = \left(\frac{\text{published rates bill} - \text{current bill}}{n}\right)$$

Where n = number of years charge increases are being phased over

If we assume that changes in bills are phased over three years, the effect of the two options is illustrated in Figure 3.3.

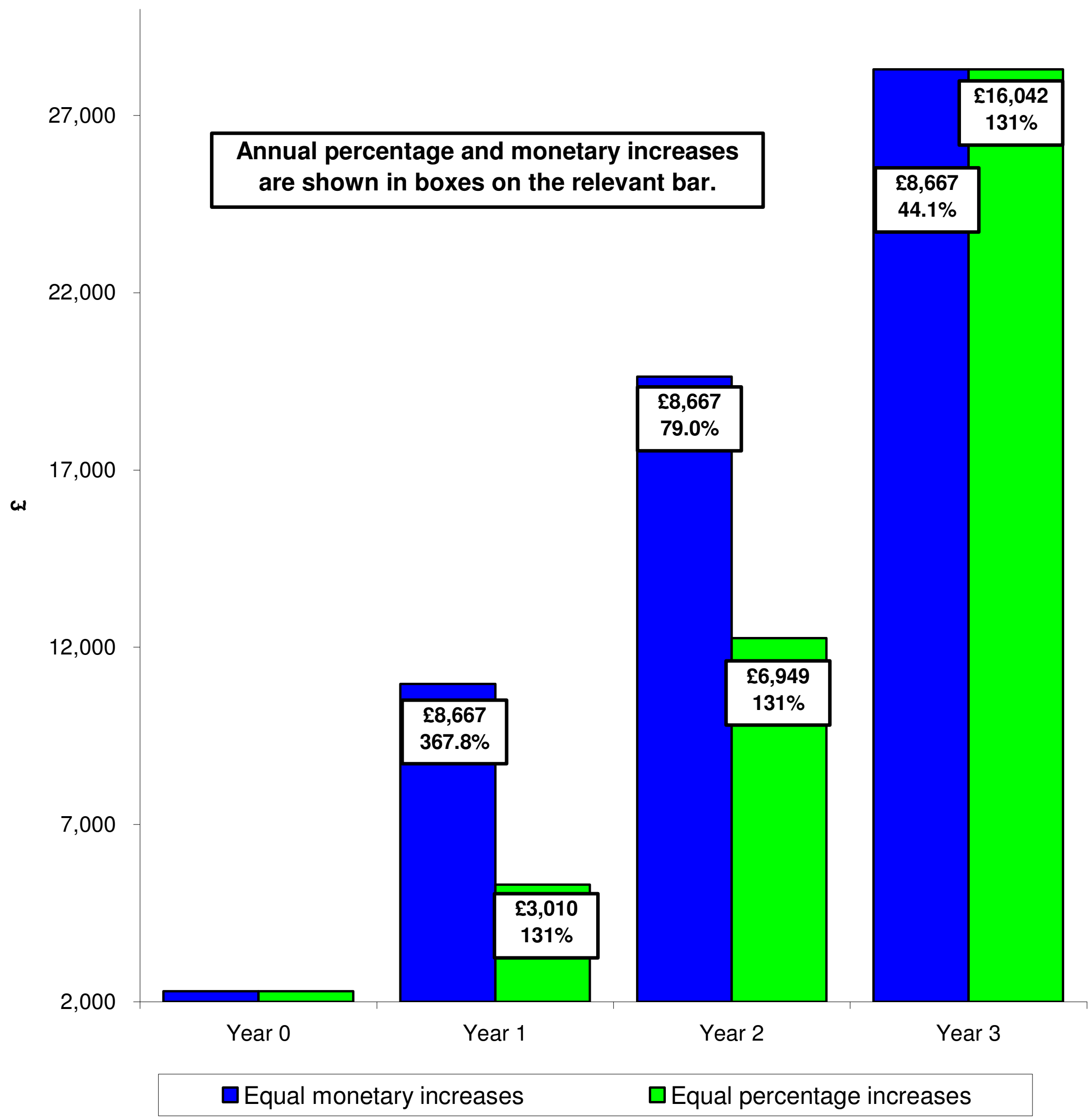
Figure 3.3: Comparison of the impact of equal percentage and monetary increases on the average customer



While both options have a relatively limited impact on the average customer, the effect would be much more marked for those customers who currently pay considerably below published rates. This is illustrated in Figure 3.4. In this example, a customer who currently pays £2,300 faces an increase up to £28,300[6].

[6] This example is based on a small hi-tech manufacturing firm.

Figure 3.4: Comparison of the impact of equal percentage and monetary increases for a large bill increase



This customer would face a very large increase in their bill in year 3.

We recognise that customers would be very concerned about large percentage increases in bills. However, in our view, it is the monetary increase in the bill that is important.

We are therefore minded to suggest that customers who currently receive discounts should face increases of a fixed monetary amount each year until they reach the published rates.

How long it should take to reach published rates

Clearly the period over which customers move onto published tariffs is important. In our view, we need to strike a balance between:

- a longer length of time, which will moderate the size of the increases that are phased in each year; and

- a shorter length of time, which lessens the likelihood of challenge either on competition or State Aid grounds.

We explained above that we are minded to approve a 'grace year' to allow customers time to plan for phased increases. If customers move onto the published rates over two years then all customers would be paying the published tariff in 2009-10. In our view this would be consistent with the time period covered by the Ministers' statement on the principles of charging.

However, we consider that there is also a case for extending the transition period. In Table 3.3 we outline the effect on an average customer of a two, three and four-year transition period.

Table 3.3: Effect of two, three and four-year transition period

	Year 0	Year 1	Year 2	Year 3	Year 4
Two-year phasing					
Bill	£9,500	£11,750	£14,000	£14,000	£14,000
£ increase	-	£2,250	£2,250	£0	£0
% increase	-	23.7%	19.1%	0%	0%
Three-year phasing					
Bill	£9,500	£11,000	£12,500	£14,000	£14,000
£ increase	-	£1,500	£1,500	£1,500	£0
% increase	-	15.8%	13.6%	12.0%	0%
Four-year phasing					
Bill	£9,500	£10,625	£11,750	£12,875	£14,000
£ increase	-	£1,125	£1,125	£1,125	£1,125
% increase	-	11.8%	10.6%	9.6%	8.7%

Clearly, a four-year transition period reduces the impact on a customer's bill in each year. However, allowing such a long transition period (a total of five years, including the one-year notice period) increases the risk of infraction proceedings on either competition or State Aid grounds.

It is therefore our view that a three-year transition may be more appropriate.

Charge caps

We consider that during this transition period the phased increases should move in line with the charge cap each year. As such, the annual monetary increase would itself increase at RPI minus 1.5% for each year of the regulatory control period. This would help to ensure that customers pay the published tariff at the end of the transition period.

Treatment caps

Most of the effluent that Scottish Water treats now receives secondary treatment. Where secondary treatment is introduced at a wastewater treatment works, bills to trade effluent customers rise significantly to reflect the additional treatment costs.

We are currently minded to require Scottish Water to introduce a capping arrangement for such customers in line with the proposals in this consultation.

Consultation questions

1. Do you consider that our proposal to allow companies a ‘grace year’ is appropriate? If not, what alternatives would you consider appropriate?

2. How should Scottish Water communicate to customers the likely change in bills?

3. Do you agree with our proposal that charges should increase in three equal monetary amounts? If not, what alternatives would you consider appropriate?

4. Do you consider that allowing three years for charges to be increased is sufficient time? If not, what time-horizon would you suggest?

5. Do you agree with our proposal that, where customers’ bills rise as a result of improved treatment, the same phasing arrangements are put in place for these customers?

4. The introduction of competition

In April 2008, a licensing framework for retailers of water and sewerage services to non-household customers will be established.

Scottish Water will continue to collect, transport, treat and dispose of trade effluent. Under the new framework, we will license retailers to carry out all ‘customer facing’ activities.

Until April 2008, Scottish Water’s own retail arm – Scottish Water Business Stream – will be the only licensed retailer. We will continue to regulate the prices it charges to customers. However, from April 2008, customers may be able to switch to alternative licensed retailers.

At that point our primary responsibilities will be to regulate wholesale charges – the charges that Scottish Water levies on retailers, including Scottish Water Business Stream. We will also approve the charges that Scottish Water Business Stream levies on customers until effective competition develops.

We do not consider that the introduction of the licensing framework should complicate the transition arrangements. In our view, customers who are part of the transition arrangements should be able to benefit from competition. As such, the full cost of the phasing arrangements should be borne by the wholesale business.

Scottish Water will therefore be required to devise a charges scheme that ensures that retailers can collect the full retail margin (in monetary terms) from each customer. We recognise that in extreme cases this may require Scottish Water to levy a negative wholesale charge during the transition.

Consultation questions

6. Do you agree with our proposals concerning how to ensure that phasing arrangements are carried out as competition is introduced?

5. Summary

Our analysis of Scottish Water's proposed scheme of charges for 2006-07 identified that large numbers of customers pay considerably below published tariffs. These discounted charges raise questions in relation to State Aid and competition law. It is therefore important that all customers (except those on separately negotiated special agreements) move onto the published tariffs as soon as practicable.

We are proposing transition arrangements whereby:

- there is a 'grace year' so that companies can plan for changes in their bills;
- there is then a transition period of three years during which time all customers move from current rates to published rates; and
- customers move onto published rates in equal monetary amounts.

We also propose that arrangements for introducing competition to non-household customers should not affect the transition arrangements. We believe that Scottish Water should pay the cost of phasing and that customers affected by phasing arrangements should be allowed the same access to competition as other customers.

We would like your views on the following issues:

1. Do you consider that our proposal to allow companies' a 'grace year' is appropriate? If not, what alternatives would you consider appropriate?
2. How should Scottish Water communicate to customers the likely change in bills?
3. Do you agree with our proposal that charges should increase in three equal monetary amounts? If not, what alternatives would you consider appropriate?
4. Do you consider that allowing three years for charges to be increased over is sufficient time? If not, what time-horizon would you suggest?
5. Do you agree with our proposal that, where customers' bills rise as a result of improved treatment, the same phasing arrangements are put in place for these customers?
6. Do you agree with our proposals concerning how to ensure that phasing arrangements are carried out as competition is introduced?

Appendix: Effect of our proposals on standard customers

This appendix summarises the percentage and monetary effects that our proposals would have on a series of standard customers. For each customer we assume three different scenarios:

- scenario A: that the current bill is 90% of published tariffs;
- scenario B: that the current bill is 50% of published tariffs; and
- scenario C: that the current bill is 10% of published tariffs.

We first introduced these customers during the process for the Strategic Review of Charges for 2006-10. The standard trade effluent customers are shown in Table A1.

Table A1: Standard trade effluent customers

Name	**Volume**		**Load**		**Average strengths**	
	Annual (m^3)	Daily (m^3)	Total suspended solids (kg/day)	Biological oxygen demand (kg/day)	Total suspended solids (mg/l)	Settled chemical oxygen demand (mg/l)
Bakery	200	0.55	0.5	0.75	575	1,600
Clothing manufacturer	12,000	32.9	1	1	20	300
Abattoir	90,000	246.6	150	250	600	1,500
Electronics business	550,000	1,507	15	50	10	75
Printers	10,000	27.4	5	40	100	2,500
Distillery	150,000	411.0	7	55	15	200

Bakery

	2007-08	2008-09	2009-10	2011-12
Scenario A				
Bill	£267.39	£277.29	£287.20	£297.10
£ increase	-	£9.90	£9.90	£9.90
% increase	-	3.7%	3.6%	3.4%
Scenario B				
Bill	£148.55	£198.07	£247.58	£297.10
£ increase	-	£49.52	£49.52	£49.52
% increase	-	33.3%	25.0%	20.0%
Scenario C				
Bill	£29.71	£118.84	£207.97	£297.10
£ increase	-	£89.13	£89.13	£89.13
% increase	-	300.0%	75.0%	42.9%

Clothing manufacturer

	2007-08	2008-09	2009-10	2011-12
Scenario A				
Bill	£5,051.30	£5,238.39	£5,425.47	£5,612.56
£ increase	-	£187.09	£187.09	£187.09
% increase	-	3.7%	3.6%	3.4%
Scenario B				
Bill	£2,806.28	£3,741.70	£4,677.13	£5,612.56
£ increase	-	£935.43	£935.43	£935.43
% increase	-	33.3%	25.0%	20.0%
Scenario C				
Bill	£561.26	£2,245.02	£3,928.79	£5,612.56
£ increase	-	£1,683.77	£1,683.77	£1,683.77
% increase	-	300.0%	75.0%	42.9%

Abattoir

	2007-08	2008-09	2009-10	2011-12
Scenario A				
Bill	£107,954.85	£111,953.18	£115,951.50	£119,949.83
£ increase	-	£3,998.33	£3,998.33	£3,998.33
% increase	-	3.7%	3.6%	3.4%
Scenario B				
Bill	£59,974.92	£79,966.55	£99,958.19	£119,949.83
£ increase	-	£19,991.64	£19,991.64	£19,991.64
% increase	-	33.3%	25.0%	20.0%
Scenario C				
Bill	£11,994.98	£47,979.93	£83,964.88	£119,949.83
£ increase	-	£35,984.95	£35,984.95	£35,984.95
% increase	-	300.0%	75.0%	42.9%

Electronics business

	2007-08	2008-09	2009-10	2011-12
Scenario A				
Bill	£191,682.05	£198,781.39	£205,880.73	£212,980.06
£ increase	-	£7,099.34	£7,099.34	£7,099.34
% increase	-	3.7%	3.6%	3.4%
Scenario B				
Bill	£106,490.03	£141,986.71	£177,483.38	£212,980.06
£ increase	-	£35,496.68	£35,496.68	£35,496.68
% increase	-	33.3%	25.0%	20.0%
Scenario C				
Bill	£21,298.01	£85,192.02	£149,086.04	£212,980.06
£ increase	-	£63,894.02	£63,894.02	£63,894.02
% increase	-	300.0%	75.0%	42.9%

Printers

	2007-08	2008-09	2009-10	2011-12
Scenario A				
Bill	£13,849.74	£14,362.69	£14,875.65	£15,388.60
£ increase	-	£512.95	£512.95	£512.95
% increase	-	3.7%	3.6%	3.4%
Scenario B				
Bill	£7,694.30	£10,259.07	£12,823.83	£15,388.60
£ increase	-	£2,564.77	£2,564.77	£2,564.77
% increase	-	33.3%	25.0%	20.0%
Scenario C				
Bill	£1,538.86	£6,155.44	£10,772.02	£15,388.60
£ increase	-	£4,616.58	£4,616.58	£4,616.58
% increase	-	300.0%	75.0%	42.9%

Distillery

	2007-08	2008-09	2009-10	2011-12
Scenario A				
Bill	£61,011.69	£63,271.38	£65,531.08	£67,790.77
£ increase	-	£2,259.69	£2,259.69	£2,259.69
% increase	-	3.7%	3.6%	3.4%
Scenario B				
Bill	£33,895.38	£45,193.85	£56,492.31	£67,790.77
£ increase	-	£11,298.46	£11,298.46	£11,298.46
% increase	-	33.3%	25.0%	20.0%
Scenario C				
Bill	£6,779.08	£27,116.31	£47,453.54	£67,790.77
£ increase	-	£20,337.23	£20,337.23	£20,337.23
% increase	-	300.0%	75.0%	42.9%