4. Written Responses – Questions

The Government's Proposal

1) Do you agree, in principle, that vacant non-household properties should be charged for water, sewerage and drainage services?

Yes ☐ No x☐

While we understand the rationale for charging vacant properties, we are very concerned that no assessment appears to have been made of the additional costs and risks that would result from this proposal.

In particular, we are concerned about:

- The substantial set-up and ongoing operational costs that would result from having to trace and bill property owners.
- The much higher risk of bad debt that would be associated with these accounts, which we and other Licensed Providers, would have insufficient means of managing.
- The fact that these costs and risks would all be placed on the retailers, while Scottish Waters wholesale revenue would be guaranteed, which would lead to significant distortions in the market.

The effect of this proposal will be a significant net increase in the costs and risks to retailers operating in the Scottish market. As a consequence, we do not believe this proposal will deliver the anticipated benefits to customers.

Increased risk

This proposal significantly increases the risk of bad debt on retailers and could distort the market. LPs pay the wholesale charge in full and in advance, and carry the whole of the risk that customers do not pay. At market opening, this was justified on the basis that LPs could use the threat of disconnection to mitigate this risk. Experience has shown that this does indeed keep the risk manageable. However, this threat would be far less effective if the property is vacant, and the owner will suffer no immediate impact from it. Adding 40,000 new customers to the market for whom disconnection is not a threat would fundamentally undermine the ability of LPs to manage bad debt risk.

We have already seen the impact on bad debt levels where we are unable to disconnect customers, as this is the case in shared supply situations, where we cannot disconnect because it would also cut off another customer's supply. In comparison to an average bad debt cost of around 1.5% across our whole customer revenue base, bad debt provisions on shared supply accounts are in the region of 35 – 40%. Despite representing less than 1% of our total revenues, shared supplies account for over 10% of our aged debt.

We can therefore make an informed estimate of what the bad debt levels on vacant properties would be. Given that many property owners will be institutions and large commercial organisations, we would not expect the same level of provisions as on shared supplies, so it would be more reasonable to estimate bad debt costs of 20 – 25%. Since £15m of wholesale revenue represents approximately £18m of retail charges, this would result in £3.5 - £4.5m of additional costs. This is a real increase in costs resulting from the proposals that would be borne by retailers not Scottish Water.

If LPs experience a large increase in bad debt and debt management costs, then ultimately these will be passed on to their customers through reduced discounts. These costs would not be evenly spread across the market – since Business Stream has a disproportionately high share of vacant properties (93% of the total), a greater amount of these costs will be borne by our customers. This is likely to result in more customers switching, creating a vicious circle as the remaining customers are then left with a higher share of the costs. This is in contrast with the existing situation, where the costs of services for vacant properties are evenly spread across all occupied premises via the wholesale charge.

While Business Stream currently owns the vast bulk of vacant SPIDs, as the market continues to develop, the consequences of properties becoming vacant in future will be to introduce a new market risk for all retailers. Accordingly, they will either need higher returns from the market to compensate for this, increasing the total costs of the market, or it will act as a deterrent to market entry.

Given these issues, if charging for vacant properties is introduced, then it would be essential for the wholesaler to carry a share of the increased costs associated with the bad debt risk. There are several possible ways that this could be achieved:

- If LPs make reasonable efforts to trace and bill an owner, but either cannot find them or are unable to recover the charges, then the wholesale charges for the property would be cancelled.

- Wholesale charges for vacant properties would only be applied once an LP had confirmed that the owner had paid an initial bill.

- The wholesale charge unit rates could be significantly reduced for vacant properties to reflect the increased bad debt risk. This would result in increased margin for retailers to cover the increased costs.

Operational issues and costs

As well as the increase in risk, these proposals will add to operational complexity, requiring substantial setup and ongoing costs.

Tracing owners
The proposal would require retailers to trace and set up billing details for 180,000 property owners. By definition, the owners of properties are more difficult to identify than the occupiers. The SAA and the Land Registry both contain some data on owners, but neither is complete, and can be time-consuming to search. Specialist search companies exist, but these also involve significant cost. The market is considering setting up a Landlord Charging Portal, which, although a critical tool to help trace owners, will not be comprehensive, particularly since there will be no legal obligation on landlords to update it. These difficulties are likely to be even greater for properties owned by overseas companies or institutional investors.

Billing owners
The difficulty in collecting these charges will be even greater. Owners will not be inclined to pay for a service from which they perceive no obvious benefit. We have already described how the threat of disconnection is unlikely to be effective in dealing with owners. While legal action could be taken to pursue debts, this is not practical for small amounts – we estimate that the average annual charge for a vacant property will be around £400. In the case of overseas landlords, it could be very difficult to serve notice on the owners, and impossible to actually chase them down. As a result, both debt management costs, and the level of bad debt provisions will be many times higher than for occupied properties. This would introduce a new cost to the market.

Operational costs
The additional costs associated with administering these accounts would include:

- In order to create owner accounts for all 180,000 properties in the market, LPs will first have to adapt their billing systems to be able to record these, and then enter the data for each individual property. Market rates for tracing and setting up an account can be up to £135.
- The market's Central Systems would also have to capture this information and to recognise whether a property is being charged on the basis of owner or occupier, requiring further development costs.
- The development of the CMA landlord charging portal– this is currently estimated at £400,000.
- As described above, there will be more frequent use of legal action, which costs an average of £250 per case.
- The process of a customer moving out will become more time consuming and therefore costly, since it will involve the setting up and invoicing of an owner account until a tenant moves in, possibly only for a few weeks, following which LPs would need to close the owner's account, then set up and invoice the new tenant.

The consultation estimates that this change would generate £15,000,000 in additional wholesale revenue, but does not take any account of the significant increase in retail costs that would also be incurred as a result.

Business rates/other utilities

The consultation states that introducing charges for vacant properties would bring the water industry into line with both business rates and other utilities. We do not think this is a valid comparison, however. In the case of business rates, there is no split between wholesale and retail functions, which means that the problem of increased bad debt for the retailers does not arise – anything that the councils recover from vacant property owners is a straightforward increase in their revenue with minimal administration costs. In this situation, risk and reward are balanced because they sit with the same party, whereas the separation of retail and wholesale in water means that the risk sits entirely with the former, but the bulk of the reward goes to the latter. The effect of making the retailers liable for £15m of new revenue, regardless of whether they can recover this from customers, will be to create a large unmanageable liability for the retailers. In addition, the fact that charges for water are substantially lower than those for business rates means that taking legal action to recover them will often not be a cost-effective option.

While the energy and telecoms industries do have a similar division between wholesale and retail, there are also significant differences. In particular, the fixed charges for water customers in Scotland – those that would continue to apply to vacant properties – make up a much higher proportion of the overall charges than the equivalent vacant charges for other utilities. This means the bad debt costs would be proportionately higher. In addition, disconnections are generally easier to carry out in energy and telecoms, making this a practical alternative for long periods of vacancy. Finally, having consulted with energy market professionals, we were told that it took at least 6 years to build up a sufficient level of data on property owners to be able to bill these premises properly. This underlines the level of set-up costs involved in a proposal of this sort, and further reinforces the question of whether it passes a cost-benefit analysis.

Conclusion

In summary, we have serious concerns over the risks created by this proposal, as well as the scale of costs associated with its setup, and therefore we recommend that it not be introduced. If the Government does decide to implement it, then it is essential that the arrangements include some way of sharing the risk and reward of it more fairly between retailer and wholesaler, and we have described a number of options for doing this.

The primary justification for implementing this change is to end cross-subsidies, and to restrict increases in the charges paid by non-household customers. However, as we have demonstrated, the new costs and risks that would be created as a result would mean that neither of these objectives could be fully met:

- Based on our experience of bad debt where disconnection is not a threat, we estimate that there could be up to £4.5m of new costs to retailers resulting from non-payment by customers.
- There will be setup costs for the industry that could amount to several million pounds.
- Cross subsidies would still exist, to pay for these new costs, and for those customers that do not pay. However, these would be spread in a much less equitable way, since they would be primarily imposed on the customers of those LPs with the greatest proportions of vacant properties.

While the current arrangement means that the costs of providing drainage services to vacant properties are carried by occupiers, it does allow the cost to be spread evenly across the entire market. If charging were introduced, then there would be serious distortions to the way the market operates, and the burden of additional costs would fall on some customers more heavily than others, depending on the number of vacant sites owned by their LP.

Since the wholesaler's costs will remain the same regardless, but retailers' costs will increase, the proposal will also increase the overall costs of the market. As a result, the existing arrangement remains the most efficient way of recovering Scottish Water's costs.

Given the scale of the impact that these proposals could have on the market, and on Business Stream in particular, we would like to request a meeting so that these issues can be discussed in more detail before any decision is taken on this matter.

2) Do you agree that water and sewerage charges for vacant properties should be the same as those for occupied properties regardless of the reason for the vacant status?

Yes ☐ No x☐

We do not agree with this. If charging is going to be introduced for vacant properties then we believe this should be limited to drainage only, to limit the level of bad debt that will be incurred on these accounts. In addition, the wholesale charges on drainage would come to around £15m/year ie the amount that Scottish Water has budgeted for in their business plan. If further charges were included on top of this, then they would be likely to over-recover what they need.

Charges – Drainage Services

3) Do you agree that drainage charges should be the same as those for occupied properties?

Yes ☐ No x☐

As described above, we believe that the costs and risks involved with charging for vacant properties heavily outweigh the benefits that it would bring. However, if this does go ahead, then this would be our preferred option.

Timetable for introduction

4) Do you agree that the current exemption should be removed from 1 April 2017?

Yes ☐ No x☐

Given the operational challenges involved in starting to bill for vacant properties, including the gathering of data on owners, the creation of a new landlord portal, and system changes for both retailers and the CMA, along with the setting up of 180,000 new accounts, we do not think it would be feasible to introduce this in time for April 2017. It is important to note that the opening of the English market, and the requirements to have systems and processes prepared for it, will absorb a huge amount of the resources available to market participants over the next 18 months. It would be extremely risky to add these further burdens on at the same time.