

Confidential to OFWAT

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Dear Ynon

Response to OFWAT Consultation: Charging Scheme Rules for 2016-17 and future developments

This response is provided for and on behalf of Independent Water Networks Ltd ("IWNL") a member of the Brookfield Utilities group. We welcome the opportunity to respond to the above-mentioned consultation (the "Consultation").

On a more general note, we support Ofwat's efforts in facilitating a water and wastewater market in which prices are intended to be transparent, fair and cost-reflective and thus support the work currently being undertaken to ensure the successful opening of the non-household retail market in 2017.

We would also like to support Ofwat in developing charging rules that require incumbents to recognise and develop tariffs for each of their key customer groups, including the class of customers known as inset appointees who in many cases substitute the role of the incumbent for the local distribution system, as well as retail functions. As yet, incumbent monopolies have not developed any 'fair and affordable' and cost-reflective charges for inset appointees which properly take into account the substitution of the local distribution system.

Yours faithfully,

Mike Harding
Head of Regulation

1. Response to consultation questions.

Q1: Do you have any specific views on the draft rules for 2016-17 included in appendix 2? Are there any other rules that you consider should be included?

We broadly support the rules. However, we do have specific comments with regards to the following rules:

Rule 8. Undertakers should carry out a proportionate impact assessment whenever the nominal value of bills for a given customer type (assuming a constant level of consumption) is expected to increase by more than 5% from the previous year.

We support the requirement for incumbents to carry out an impact assessment under these circumstances but do not consider it appropriate to impose this obligation on new entrants on the grounds that (a) new entrant tariffs are capped by the incumbent 'all the way' tariffs and (b) IWNL offer price discounts that are determined by the margin between the incumbents published 'boundary' and 'all the way' tariffs.

The significance of this is that IWNL's domestic customers experience the compound effect of not only changes to the incumbent's domestic measured tariffs but also changes to the IWNL discount. To highlight the point, IWNL's 5% domestic volumetric water discount at King's Cross was entirely eroded from one year to the next because Thames Water squeezed IWNL's margin by increasing their 'boundary' tariffs by more than their domestic 'all the way' tariffs.

Rule 8 also requires undertakers to carry out a "proportionate impact assessment", but does not set out any guidelines or principles to be followed nor does it indicate whether undertakers should consult on charging increases beyond the threshold. We would propose that undertakers be required to apply similar principles as those set out in Ofwat's policy on impact assessments dated April 2011 and to comply with the guidance and toolkit on impact assessment from the Department for Business, Innovation and Skills (BIS).

Principles for determining the amounts of charges – Rules 12 to 17

Whilst we agree with these underlying principles for setting charges, we do not see how it is possible that IWNL can be required to comply with these rules as our charges are fixed by reference to incumbents' charges.

Rule 26: Rule 9 does not apply to new appointees. Instead new appointees must publish charges schemes no later than the 22 February immediately preceding the Charging Year in relation to which they have effect.

IWNL does not believe 21 days is sufficient as we cannot start setting tariffs until we know the tariffs of the regional incumbents. It is common for the incumbents to publish their tariffs on or very shortly before the statutory deadline. This typically means that IWNL only has 21 days to start and complete the process. This short time frame is further compounded by the fact that IWNL must calculate site specific discounts and therefore site specific tariffs

for each of its appointed Inset sites. These tariffs must then be updated to IWNL's charging schemes and approved by the IWNL board before publication. It would therefore be helpful if this deadline could be extended to no later than 1 March.

IWNL have considered the possibility of simplifying and streamlining the tariff publication process by simply publishing a scheme of charges which refers customers to the relevant incumbent web portal / scheme of charges. IWNL's approach to site specific discounts would need to be rationalised or removed to make this possible. IWNL would welcome views from Ofwat on whether or not an approach which allows new entrants to reference the incumbent's published tariffs in their charging schemes would be acceptable.

Annex: Information Requirements

A1(b) The Board has assessed the effects of the new charges on customers' bills for a range of different customer types, and approves the impact assessment and handling strategies developed in instances where bill increases for particular customer types exceed 5%.

IWNL does not consider this requirement relevant to IWNL – see comment above on Rule 8.

A2. Each undertaker should provide to the Water Services Regulation Authority a statement setting out any significant changes anticipated by the undertaker, and publish the statement, at least three weeks before the publication of the charges scheme.

This paragraph pertains to significant changes in the context of price increases of more than 5% to customers from the previous year. IWNL depends on incumbents for this information and its own charges are fixed against these charges. Any such significant changes will be passed through to customers, subject however to any volumetrically based discounts for water supplies. We do not believe that this paragraph should apply to IWNL.

A3 In addition to the assurance set out above, new appointees' assurance statements must include assurance that their charges schemes offer:

(c) prices equivalent to those specified in the new appointee's application for each individual appointment or variation area.

Ofwat applies a "no worse off" assessment criteria in considering inset applications. Customers are not required to be better off. Nevertheless, in securing a competitive advantage IWNL voluntarily offers customer volumetric discounts as set out in its inset application and of course we wish to reserve the flexibility to increase or reduce these voluntary discounts from time to time. IWNL already operates with thin margins and should be able to reduce any customer discounts to counter the effect of any margin squeeze caused by increased boundary charges.

Q2: How best can site area-based surface water drainage charges be adopted? And what lessons can be learned from how companies have moved to this basis so far?

Planning requirements for new developments generally require storm water to be separately collected and discharged to the local environment by way of a sustainable urban drainage system. The costs associated with constructing and operating these systems can vary.

IWNL typically submits its bids at a conceptual or outline planning stage i.e. before detailed site plans have been drawn up. Consequently it is difficult if not impossible to form a view on the level of area based drainage charges that it may receive when the site is fully built out. The impact of this is twofold, firstly the developers will generally have to bear a large proportion of the drainage system construction cost and secondly IWNL bears the risk of not receiving sufficient income to operate and maintain the SUDs system on an ongoing basis.

Q3: Do you agree with our proposed threshold for 'significant' bill increase? If not, is there evidence for a more suitable threshold? And how this can be assessed for different customer types?

We support a 5% threshold for incumbents.

Q4: Do you agree with our current preference for companies publishing their Board's assurance statements?

IWNL supports the publication of company Board's assurance statements.

Q5: Do you consider that the Board's assurance statement should cover anything else than what we propose above?

See our answer to Question 1 above.

Q6: Do you agree with our current preference for companies to submit a statement of significant changes?

Yes, subject to our comments in response to Question 1 above.

Q7: Do you have any specific views on the proposals included in chapter 4? Are there any other rules or issues that you consider should be consulted on next year?

IWNL supports the process that Ofwat is undertaking in setting rules about wholesale charges. We also agree in principle with Ofwat that transparency and cost-reflectivity of wholesale charges will be vitally important to ensure an effective non-household retail market.

Completeness of wholesale charges scheme

We support the publication of complete wholesale charges schemes, including non-primary charges. Regional incumbents have published these previously so that requiring this to continue should not place any undue burden on companies. In any event, the requirement to publish complete wholesale charges is consistent with the notion of transparency and it provides retailers with access to all of the products and services on the market. Wholesalers should not be able to charge for any product sold in the market using a tariff that is not in its wholesale charges scheme.

Timing of publication of wholesale charges

We support the earlier publication of wholesale charges to allow new entrants more time to compete for customers before the charging year commences. We also recognise, however, that materially inaccurate data will negate any potential benefit to retailers. We support Ofwat's suggested use by all wholesalers of the Office of Budget Responsibility RPI projections to obviate any material differences between indicative and actual charges.

In Ofwat's recent workshops for small companies, Ofwat recognised the challenges faced by new appointees in relation to the preparation and publication of wholesale charges including access charges. Any such charges will be subject to relevant charges imposed by regional incumbents. Whilst we recognise the need for our non-household retail customers to be able to participate in the new market and to switch their supplier, it is imperative that Ofwat imposes a proportionate approach, not only to new appointees' requirements to publish wholesale charges, but also to new appointees' requirements to comply with the new market arrangements. We would support the creation of more focused workshops to address small company concerns and reducing the regulatory burden on such companies, particularly with regards to:

- The need to prepare and publish wholesale access charges;
- The need to communicate with the MO and prepare customer data, the content of such data and the format in which such data must be provided;
- Understanding and complying with the various processes and procedures set out in the industry codes.

Special Agreements

To give effect to pricing transparency, IWNL supports the notion that services provided under special agreements should be contestable and that water companies be required to disclose special agreement terms.

Deemed contracts

We broadly support an industry approved set of terms for the creation of a deemed contract to support the interim supply code. IWNL welcomes an opportunity to respond further to the October consultation in which Ofwat intends to consider its interim supply proposals in more detail.

Disaggregation of wastewater charges

The disaggregation of wastewater charges seems reasonable in principle but IWNL cannot support this proposal until such time that the incumbents are also required to develop separate new entrant tariffs. We believe that without new entrant tariffs, the proposed disaggregation will introduce further barriers to competition.

One of the key problems faced by new entrants is that the structure of 'all the way' tariffs often differs from the structure of 'boundary' tariffs. This disparity in tariff structure can lead to stranded costs. A simple example of this is the peak demand charge levied by Anglian Water at the boundary. This tariff may set suitable price signals for some commercial customers, but does not serve that purpose where IWNL are taking a bulk supply for domestic purposes. IWNL can neither discourage nor influence how domestic customers use their water because Anglian does not impose a peak demand tariff on domestic customers and we are required to charge in line with their household tariffs. So if all customers on an IWNL site in the Anglian region choose to turn their taps on simultaneously IWNL incurs a punitive peak demand charge which it is unable to pass through to the domestic customers whose use of the network caused the charge to be incurred.

There is a very real risk that adding more granularity to the boundary tariffs i.e. by disaggregating the wastewater charges will extend the problem of disparate 'all the way' and 'boundary' tariff structures across all water company regions and thus cause new entrants to incur further stranded costs.

Standardisation of charges

IWNL strongly believes that the market reforms are significantly more likely to succeed if there is a requirement to standardise not only the charging structure but also the charging methodologies that underpin them.

IWNL is certain that allowing incumbents the flexibility to innovate on tariffs presents much greater danger to the market than the benefit it may have to consumers. Firstly, there is the opportunity for incumbents to abuse their dominant position to set charges that discourage competition from new entrants. Secondly there is the very real risk that one incumbent will choose to allocate its costs in a completely different way to another which in turn could produce an entirely different price signal to other water companies.

IWNL is aware that 'tariff innovation' is already foreclosing competition and sending disparate price signals. For example, the difference in income that a new entrant can earn varies significantly depending on which incumbent region the site is being built. The variations in income are counterintuitive given that the costs of owning and operating the site network do not materially change just because the site is located in one region rather than another.

Some of the difference in new entrant income is being driven by the fact that different water companies are choosing to have different tariff thresholds. These thresholds may seem reasonable within the individual ring fenced monopoly markets but will take on an entirely different role in an open competitive market. This has been seen in the electricity and gas markets where suppliers have introduced different tariff thresholds specifically to combat the increase in customer churn being caused by price comparison sites such as USwitch. The suppliers' motivation is not to offer better value to customers but actually to retain customers by making price comparison more difficult for both the customers and the web sites that offer the comparison service.

The variance in new entrant income between different regions is also being driven by different cost allocation methodologies. When Ofgem urged the electricity DNOs to develop new tariffs for new entrant IDNOs it highlighted that not all of the DNOs had the correct level of economic, commercial and competition law knowledge to undertake the task. It also highlighted that there were a multitude of legitimate different ways that different costs could be allocated. A great deal of time and resource was wasted on the part of the DNOs, the IDNOs and the regulator in trying to manage the implementation of 14 different methodologies before a decision was finally taken to pool knowledge and resource and develop a single common charging methodology and tariff structure. The implementation was swift and effective following this decision. The DNOs were no longer individually exposed to a complaint, the regulator de-risked the likelihood of having to manage numerous concurrent complaints and a governance process was introduced to provide a platform for ongoing refinement.

A decision to implement a common charging methodology and charging structure in water offers the same benefits and will help to fast track a much smoother transition for the market reforms.

Charging rules for developer services

We agree that the current charging framework for connections to new developments lacks transparency and is unnecessarily complex. The current regime is poorly understood by developers and even by many in the industry. There are significant differences between undertakers and navigating the connections regime causes unacceptable delay.

We would like to reiterate our view presented in response to DEFRA's consultation on the charging guidance, i.e. that it should be possible for developers to produce a good estimate in advance of the costs of particular solutions. This will enable better design. Similarly, inset appointees should be able to form a reliable view of the cost of different solutions so that they can offer the most efficient and appropriate proposals to developers.

Charging rules for access pricing

We are pleased that Ofwat will be consulting separately in December 2015 on the charging rules for access pricing. We recognise that this will be a significant piece of work and believe that all changes will need to be aligned under one implementation to minimise the risk of any unforeseen and detrimental impacts that may be caused by launching wholesale charges before access charges are ready.

IWNL is currently considering its position on wholesale charges and is concerned by the cost plus dilemma faced by new entrants in respect of having to (a) pass through the incumbents wholesale boundary charges and (b) having to add IWNL's own costs for owning and operating the last mile network on top of the incumbents wholesale prices.

The concern is that the incumbent's wholesale tariffs reflect the cost of the incumbent providing the network all the way to the customers premises rather than to a site boundary. The implication of this is that new entrants will be forced into a position where they will have to develop significantly higher tariffs for each equivalent price tier than those of the incumbent. i.e. because the incumbent has not unbundled the last mile costs from their boundary tariff. This could lead to complaints from water suppliers that they are unable to compete on Inset developments and complaints from non domestic end customers that they are not able to benefit from the market reforms.

Q8: Would it be practicable and/or desirable to include all non-primary charges in the wholesale charges scheme?

Yes, see our response to question 7.

Q9: Do you have any specific views on the requirements to publish final wholesale charges for non-household customers no later than the first week of January?

No subject to the separate provisions for new appointees.

Q10: Do you agree with our outline proposal that indicative wholesale charges be published in July and October?

Yes.