21 April 2016

Charging
Ofwat
21 Bloomsbury Street
London
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Sent by email to: charging@ofwat.gsi.gov.uk.

Redacted version for publication

Dear Ofwat,

Response to Ofwat's discussion paper on new connections charging – emerging thinking for discussion (24 March 2016)

We welcome publication of the discussion paper which sets out Ofwat's emerging thinking on how charging rules for new connections could potentially meet the UK Government's charging objectives, and address the key issues with the existing framework.

Our detailed comments and responses to Ofwat's questions are provided in an appendix to this letter. In summary, we believe there is a need to review the charging rules because the existing charging rules unduly distort competition in favour of the incumbents own "notional" downstream business.

The incumbent provides a subsidy, which is funded by their wider customer base, when it provides or adopts the assets for new developments. However, where the assets to the same development are to be owned and operated by parties under the new appointment and variations ("NAVs") regime, the incumbent offers no such subsidy; i.e. the incumbent is willing to subsidise its own notional downstream business from its wider customer base, but not that of competitors.

Another fundamental issue are the boundary tariffs charged to NAVs, which are set by the incumbents. Such charges do not reflect the total avoided costs when compared to the total efficient costs incurred by the incumbent when it operates the same network. Such tariffs will include an element of the cost recovery of the cross subsidies provided in financing asset values for other sites. Whilst we understand that this consultation does not specifically address tariffs, we believe that this has to be considered at the same time since we believe there is a clear inter-relationship between tariffs and connection charges. It is noted that incumbents will be undertaking work already to better understand their costs in order to develop charges to facilitate the opening of the retail market to competition. Therefore, it would appear to us that charges to NAVs should be considered at the same time.

IWNL propose a new paragraph 18, which will ensure that there is no discrimination against NAVs (or SLOs). The intention is that any subsidy provided to developers when contracting Undertakers directly should also be made available to them when using NAVs or SLOs instead.

This one small amendment could make a huge difference to the viability of competition for the installation of new residential networks.

This new paragraph 18 is explained in more detail in our response to question 8 and states:

"*In setting charges in accordance with the present rules, Undertakers shall take reasonable steps to ensure that for any particular site the net cost borne by the Undertaker and its other customers is the same whether:*

(a) the Undertaker provides all on-site and off-site infrastructure; or

(b) part of the infrastructure is installed and/or adopted by another person.

'Net cost' in this Paragraph 18 means the difference between: (i) any Site Specific and Network Reinforcement costs incurred by the Undertaker; and (ii) any charges imposed on or payments made by the Undertaker to the Developer or other person, as appropriate."

We recognise that this is a complex area and would therefore welcome the opportunity to discuss our thoughts in more detail with you.

Yours faithfully

Mike Harding
Head of Regulation

Appendix 1

Detailed Response from Independent Water Networks Limited ("IWNL")

Introduction

IWNL welcomes the opportunity to respond to Ofwat's consultation. The thinking developing now on new connections charging could have a profound impact on competition for the provision of new residential water infrastructure.

As you know, IWNL's interest is in new appointments and variations ("NAVs"). It competes with incumbent water and sewerage undertakers to provide networks for new developments. The new developments it serves are primarily residential and require connections for domestic purposes – the type of connections that are the focus of your consultation. IWNL typically provides new water and sewerage networks alongside the provision of new gas, electricity, telecoms and/or district heating networks that is installed by sister companies in the same Brookfield Utilities UK ("BUUK") group. It is this "one-stop-shop" approach which is one of the particular attractions for developers.

IWNL has demonstrated to Ofwat that the current charging structure prevents competition in c95% of the market for the provision of new water and wastewater infrastructure. The bulk boundary charges offered by incumbent water companies do not provide sufficient margin to enable an equally efficient new entrant to compete. These bulk supply tariffs do not reflect the fact that IWNL is providing the "last mile" of infrastructure that the incumbent would otherwise have to provide and do not allocate total costs to NAVs in the same way as the incumbent does to its own "equivalent" notional downstream business.

Further, the current relevant deficit mechanism hinders competition as it enables the incumbent to offer a significantly greater asset value to SLO providers than a competing NAV is able to when bidding to adopt (acquire) the network. This is because the incumbent funds the asset value from its wider customer base; i.e. a cross subsidy. This cross subsidy gives the incumbent an undue competitive advantage over a competing NAV in gaining the ownership of the assets.

The position in water contrasts sharply with electricity and gas, where there is a vibrant competitive market for ownership of assets on new developments. This creates an equally competitive market for installation of the utility infrastructure, as installers can choose the asset owner that they want to partner with for each site. The sector also benefits from full competition in supply (retail).

IWNL welcome Ofwat's objective to create a level playing field to address the issues we have identified. The water sector has a unique opportunity to create an equally vibrant market with full competition in installation of assets, asset ownership and the supply of water. As witnessed in the electricity and gas sectors, this brings increased efficiency, improved levels of service, investment and innovation. This will play a key role in supporting the UK strategy to increase the rate of new build properties and will help Ofwat meet its objectives for connections without as much reliance on regulation. Thus, for example, developers will benefit from better service delivery performance and more predictable charges even without regulatory coercion because, to the extent they matter to developers (as they do), they will feature as elements of the competition between NAVs and incumbents. Incumbents will lose contracts to NAVs unless they improve what they are doing.

In these circumstances, it is encouraging for us to see Ofwat reiterate its commitment to "*ensuring a level playing field for SLOs and new appointees and variations (NAVs)*".[1] We are, though, concerned that this commitment is not reflected in the proposals for the new connection charging rules. There are, in fact, elements of the proposals that could actively undermine competition between NAVs and incumbents as they stand. In particular, maintaining or increasing the incumbent contribution to the cost of on-site works without requiring the incumbent to make a comparable contribution to NAVs will foreclose competition at the vast majority of sites (as is currently the case).

IWNL appreciates that the focus of this consultation is on the charges levied on developers, rather than the wholesale charges levied on NAVs, but it would be straightforward to tweak the draft charging rules to achieve a positive result in both respects. Incumbents are already investing a lot of effort to understand their costs better in order to support retail market opening as well as creation of a new connection charging regime so it makes sense to take advantage of that improved understanding to deal with charges to NAVs at the same time.

Q1: Have we missed any key issues with the current framework?

Whilst you have acknowledged the need to ensure a level-playing field between NAVs and incumbents, you have not identified how the connection charging rules affect that competition and what is needed in that regard to help create the level-playing field you seek.

(i) *Explaining the issue*

The key issue in this respect is the implicit subsidy provided by an incumbent's existing customers to the developer of a new site.

IWNL agrees that it would not be right for developers to pay all the costs associated with connection because that would not take into account that water companies receive a benefit from having more water bill payers.[2] We also have no objection to the suggestion that the current balance of contributions to costs by developers and bill payers should be broadly maintained.[3] Where the problems arise is in how the subsidy is provided. To create a level playing field the incumbent has to make this support to NAVs as well as directly to developers.

Where we stand at the moment is that there is disagreement between incumbents over whether they have to give NAVs the benefit of any subsidy at all. Some adopt the position that NAVs are not entitled to make a requisition under the WIA and must therefore pay the full cost of any work required by the incumbent without any discount at all. The NAV cannot then compete against the subsidised connection offer made by the incumbent directly to the developer.

Others adopt the slightly more reasonable position that they should run some form of calculation similar to a "relevant deficit" calculation but based only on the off-site costs and/or wholesale income. This still makes it very difficult for a NAV to compete against the incumbent. What no incumbent does is give the NAV credit for the on-site subsidy that the incumbent will avoid if the NAV wins the site instead. This means that the playing field is anything but level and skewed heavily in favour of the incumbent. If Ofwat is serious about its ambition to create a level playing field for SLOs and new appointees then this is an area that has to be addressed.

[1] Page 11 of the consultation.

[2] Page 15 of the consultation.

[3] Page 30 of the consultation.

The effect of this is to foreclose competition for most developments, particularly those where there are few, if any, off-site works required – which covers most smaller developments, accounting for a majority of all developments.

(ii) *A real-life illustration*

We can most easily illustrate this using a real-life example that we have already deployed in discussions with various incumbents (and which some of Ofwat's staff will have seen in that context). The example is of a site called […✂…] in the […✂…] area. We use this example because it is one of the very few where we can make a good approximation of how the relevant deficit calculation will have worked.

The […✂…] site contains […✂…] domestic plots and is typical of the many small sites that come to market each year.

Ordinarily, IWNL does not have much visibility of the incumbent's relevant deficit calculation and its DADs and/or Asset Payment offer to the developer. For […✂…], however, IWNL can produce a good approximation of the relevant deficit calculation because […✂…] confirmed that there were no off-site costs to be included in the relevant deficit calculation. IWNL can therefore fairly reliably estimate the costs of the on-site works that could have been requisitioned from […✂…]. In circumstances where most infrastructure deployment these days is carried out by self-lay organisations rather than incumbents, it is unlikely that […✂…]'s costs for installation of the network would be materially lower than IWNL itself would have incurred.

The table below provides IWNL's approximation of […✂…]'s DADs calculation for […✂…].

TABLE REDACTED

Notes:

(1) […✂…] confirmed that the development can connect to existing off-site mains without the need for reinforcement.
(2) The on-site capex is based on IWNL's assessment of the capital cost and includes a connection charge of […✂…] quoted by […✂…].
(3) The Income Per Plot is based on […✂…]'s published domestic measured average annual demand of […✂…]m^3 and prevailing 2015/16 domestic measured tariffs with no allowance for leakage, bad debt or occupancy.
(4) The DADs assumptions are understood to be standard across all water companies and have been obtained via a recent DADs calculation provided to IWNL by […✂…].

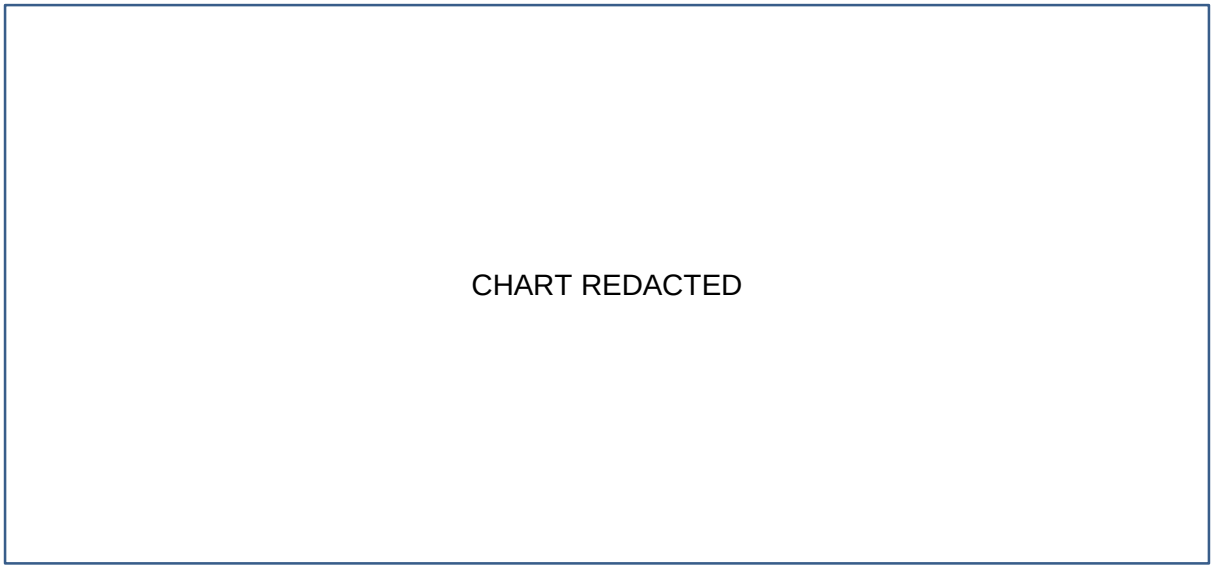
The table shows that […✂…] was able to either:

(a) Construct and adopt the […✂…] network at zero cost to the developer. i.e. the "Statutory Commuted Sum" price; or

(b) Make an "Asset Payment" of […✂…] to the developer to adopt the […✂…] network if the developer chose to appoint a self-lay contractor. To be clear, no incumbent currently would make an equivalent payment to a NAV if the NAV provided and adopted the network instead.

This is so because […✂…]'s projected income exceeded the […✂…] annual borrowing cost associated with […✂…]'s […✂…] investment in the […✂…] Water network in each of the 12 relevant years.

This application of the relevant deficit calculation enables the incumbent to acquire the new network at a zero cost to the developer. A NAV is not able to compete against this position as the incumbent does not pass a reasonable value to the NAV through the boundary charges. The chart below plots this graphically but also includes the on-site revenue that a new entrant would earn on the […✂…] development after paying […✂…]'s boundary charges.



The chart shows that a new entrant's income fails to even cover […✂…]'s own costs of financing the […✂…] network investment let alone provide any headroom for operating the network and billing customers.

This situation is economically inefficient and detrimental for customers because a NAV will not be selected to replace the incumbent even if it can provide the same services as […✂…] more cheaply or is able to provide better services. As a result, all of […✂…]'s customers collectively will pay more or get less in aggregate.

(iii) *<u>Why action is needed</u>*

There is nothing terribly unusual about the situation illustrated by the […✂…] example. As noted in the consultation,[4] Anglian Water has estimated that the current balance between existing bill payers and developers would be broadly maintained if it simply charged developers 15% of on-site infrastructure costs. Unless some of that subsidy were provided to

[4] Pages 28 to 29.

NAVs through lower off-site and/or wholesale charges, NAVs would only ever be able to compete where they could outperform the incumbent to the tune of 85% of the on-site costs. Needless to say, that would be all but impossible. It also makes no sense at all because customers would be better off if the NAV were even just 5% or 10% more efficient.

It is right that incumbents should give NAVs the benefit of a similar level of subsidy from their existing bill payers because the justification for a subsidy is that the new connection will give rise to economies of scale,[5] and those economies of scale will still wholly or largely accrue *to the incumbent* even if a NAV adopts the on-site network instead.

It is straightforward to see why this is the case. Supplying more water and/or taking on more customers allows overheads / fixed costs to be spread over greater volumes. A lot of the on-site and retail costs are variable and only, therefore, give rise to limited economies of scale.[6] It is more with the off-site costs that economies of scale accrue. Appointment of a NAV prevents the incumbent realising economies of scale associated with providing the on-site network, if there are any, but has little or no impact on the ability of the incumbent to achieve economies of scale connected with off-site costs. Everything from the site boundary onwards will normally be the same as it would otherwise have been.

(iv) <u>How the new proposals risk making matters worse</u>

One of the consequences of the current relevant deficit arrangements is that the subsidy provided varies between sites. It varies in amount and also in terms of whether it is mainly provided in respect of on-site or off-site costs (with the benefit sometimes also being given to NAVs to the extent it is provided in relation to off-site costs).

What this means is that there are a small number of sites where the total and/or on-site subsidy is sufficiently small that NAVs are able to compete whilst only being a little more efficient than the incumbent. To look at it another way, if the average subsidy equates to 85% of on-site costs (as Anglian suggests), there may be one site with only a 10% subsidy for every five (like […✂…]) with a 100% subsidy. That one site can be the subject of real competition.

If, however, the subsidy is provided in a more uniform fashion – and there are no other changes to the status quo – there are likely to be no sites where competition by NAVs is possible.

The most problematic suggestion, in this regard, is Anglian's idea that it could simply put in place a uniform rule of only ever charging for 15% of the on-site costs. Apart from the issue with uniformity, this also suggests that Anglian may treat the subsidy as accruing *only* at the on-site level and therefore giving NAVs none of the benefit of the same. Doing that would kill competition by NAVs stone dead. There would be no scope for competition at all.

Even beyond this idea, though, any move towards greater uniformity and/or increase in the flexibility afforded to incumbents is likely to make competition by NAVs more difficult. Extending asset payments to wastewater assets could be problematic in that respect because there are sites at present where it is only the lack of asset payments for wastewater assets that allows the whole site to be viable (for water and wastewater).

(v) <u>A better way forward</u>

[5] See Pages 15 to 16 of the consultation.

[6] BUUK achieves economies of scale and scope from providing multiple utilities on the same site but those are not economies that are available to an incumbent water undertaker.

IWNL can see that there could be a real customer benefit to more predictable connection charges. It also agrees that the current variation is rather arbitrary, especially the different treatment for wastewater and water assets. We would have no objection to the suggestions made, including Anglian's, provided it were ensured that NAVs would not be prejudiced.

There have been discussions, with Ofwat's support, between IWNL and various incumbents about the creation of NAV-specific wholesale tariffs that recognise that NAVs are not in the same position as other industrial and commercial users. Those discussions have shown some early promise but are still a long-way off real fruition. They could easily be rendered otiose if changes to connections charging force NAVs out of the market in the meantime.

A good interim solution would simply be to provide that incumbents cannot give developers a greater discount on total costs incurred than the incumbent is prepared to offer to a NAV for the same site. This sort of non-discrimination obligation is not particularly novel in regulation and would be easy to administer. Incumbents will know how much cost they are expecting to incur and how much they plan to charge the developer. As such, they will know how much discount they must also offer to a competing NAV. If the discount exceeds the off-site capex costs that the incumbent would otherwise charge the NAV, it should have flexibility to either offer a cash payment or a discount off future wholesale rates (or some other arrangement agreed between the parties).

This could easily be provided for by adding just one new, short paragraph to the draft charging rules (as set out in our response to Q8 below).

Q2: Do you agree with our emerging thinking to require work that is remote from the site to be recovered through infrastructure charges only, to increase transparency?

A clearer division between on-site and off-site costs would be welcome, but incumbents must be able to reduce the infrastructure charges levied on NAVs in order to ensure that NAVs benefit from the same total discount – or subsidy – as a developer would get if there were no NAV (see our response to Q1 above).

Q3: Do you agree with our emerging thinking to allow companies to develop new approaches to charging?

There is an obvious tension between allowing flexibility and innovation versus providing predictability through standardisation. IWNL agrees, however, that it may be interesting to see what different solutions incumbents come up with and perhaps then to roll-out the best practice across the industry.

Allowing incumbents to try different approaches will put them in a similar position to NAVs, which are already free to innovate without being bound by the statutory requisition requirements and which have been able to better meet customer needs as a result. IWNL would welcome more competition on the merits from incumbents. Of course, it would be deeply unfortunate if incumbents were given more freedom as to how they can compete with NAVs whilst not otherwise levelling the competitive playing field in favour of NAVs (as proposed in response to Q1 above). As noted above, the suggestion made by Anglian as to how it might charge would entirely foreclose competition by NAVs if the status quo were not otherwise adjusted.

Q4: Do you agree with our emerging thinking to promote a level playing field through increased transparency?

Transparency is important to promote a level playing field. One of the serious issues we face as a NAV is that incumbents take a very long time to give us information about the off-site works required and what they would charge for them. We have concerns, as well, that the solution offered to us may not be as good as the solution that the incumbent has assumed in making its own offer to the developer.

Ofwat is already aware of the particular issues we have had with […✂…]. In all three cases, we had to wait over a year for the provision of final technical solutions and costs by the relevant incumbent. Progress was only finally made after we escalated the matter to CEO level and involved Ofwat directly. As the technical solutions and costs are required for grant of the NAVs by Ofwat, the incumbents effectively have it in their power to prevent competition entirely. Delay also damages our relationship with the developers, making them less likely to use NAVs in the future, and reduces our ability to negotiate with the incumbent (because we cannot afford further delay). As such, delay arising from a lack of transparency directly harms competition.

Similar issues have arisen in other sectors and have been addressed effectively. In gas and electricity, for example, a self-serve model has been developed whereby licensed new entrants have access to the incumbent's network records so as to be able to ascertain such things as the level of existing capacity and the optimum connection points. This can significantly reduce the level of work that an incumbent needs to undertake and limits the risk of bottleneck delays. As such, it benefits both new entrant and incumbent. We have provided a workshop for Ofwat staff to show how these processes work in practice in gas and electricity and have offered the same to incumbent water companies. We hope it will prove possible to develop something similar in short order.

Q5: What would be the impact of requiring wastewater asset payments?

As Ofwat identifies, requiring wastewater asset payment would tend to create tension with the UK Government's guidance to broadly maintain the current balance between contributions to costs by developers and bill payers. This could be resolved by increasing the contribution required of developers towards water assets at the same time as effectively reducing their contribution towards wastewater assets, but this would obviously take some time to achieve reliably.

To simply require wastewater asset payments without reducing water asset payments would be destructive of competition between NAVs and incumbents. As indicated in our response to Q1 above, there are sites where it is only the lack of incumbent asset payments for wastewater asserts that allows us to be competitive for the site at all. To yet further increase the bill payer subsidy without giving the same benefit to NAVs would make competition even harder.

Q6: Do you agree with our emerging thinking regarding information provision from companies to improve transparency?

Yes, there will be fewer disputes over charges levied by incumbents if they are transparent about how the charges have been calculated and provide the information necessary to verify the same.

In our response to Q8 below, in relation to Paragraph 10 of the draft rules, we make one suggestion for the provision of further information.

Q7: What further information should Ofwat seek to collect from companies to aid transparency of charging in relation to new connections, as well as enabling ongoing monitoring and enforcement?

Ofwat should collect information on the total incremental costs incurred as a result of making each connection, the split between on-site and off-site costs and the amounts charged to or paid to developers (or NAVs) for the on-site and off-site works.

Routinely collecting such information would not only allow Ofwat to check that charges properly reflect the costs that they are supposed to recover but would also allow it to see how the charges affect competition. One of the challenges that IWNL has in trying to show that incumbent charges are anti-competitive is that it does not have access to the necessary information and it is not information that Ofwat routinely collects itself.

Q8: Do you have any specific suggestions on the draft rules set out in appendix A1?

IWNL would propose a new paragraph 18, as follows:

"*In setting charges in accordance with the present rules, Undertakers shall take reasonable steps to ensure that for any particular site the net cost borne by the Undertaker and its other customers is the same whether:*

(a) the Undertaker provides all on-site and off-site infrastructure; or

(b) part of the infrastructure is installed and/or adopted by another person.

'Net cost' in this Paragraph 18 means the difference between: (i) any Site Specific and Network Reinforcement costs incurred by the Undertaker; and (ii) any charges imposed on or payments made by the Undertaker to the Developer or other person, as appropriate."

This new provision would seek to ensure, in line with our response to Q1, that there is no discrimination against NAVs (or SLOs). The intention is that any subsidy provided to developers when contracting Undertakers directly should also be made available to them when using NAVs or SLOs instead.

This one small amendment could make a huge difference to the viability of competition for the installation of new residential networks.

Other amendments that IWNL would propose to the draft rules are as follows:

- The definition for "Site Specific" included at Paragraph 5(p) appears to be missing a few words and includes a typographical error ("aas").

- Paragraph 7 should be amended to include NAVs amongst those to be consulted.

- We would suggest that Paragraph 10 may not go far enough in distinguishing only between "contestable" and "non-contestable" services. As currently defined, the distinction between "contestable" and "non-contestable" services is based on work or services that only a Water or Sewerage Undertaker may provide. There can, however, be a further sub-division of "non-contestable" works and services between those that only the incumbent Undertaker can provide and those that can be provided by a NAV, if appointed. We would suggest that it may be helpful for Developers if the cost of the "contestable" works were further sub-divided in that way. In any event, we note that

Paragraph 10 does not currently use the capitalised terms that have been defined in Paragraph 5.

- Paragraph 14 could be misinterpreted as meaning that it is not possible to change the charging arrangements for NAVs since NAVs would, in principle, be included within the description of "other customers" and Paragraph 14 requires the "*present balance of charges between Developers and other customers [to be] broadly maintained*". It would be sensible to amend the wording to expressly exclude NAVs from the description of "other customers", but a suitable alternative might just be to confirm the intent in any accompanying statement.

Q9: Do you consider it to be appropriate for Ofwat to set requirements for companies to engage with their stakeholders as part of the charging rules?

Yes. We would only add, as noted in response to Q8 above, that the persons to be consulted should include NAVs.

Q10: Do you consider that any additional actions will be required to ensure an effective transition?

We agree that there is a linkage between the new connection charges and wholesale charges. We agree that it makes sense to transition both together. We would suggest, however, that quotations provided on the basis of the old arrangements should remain valid after the introduction of the new arrangements. As indicated in response to Q4 above, we have experienced some very severe delays in the provision of quotes by incumbents. If old quotes will lapse when the new arrangements come into place, this may cause developers to abandon long-running discussions with NAVs to avoid losing the old quote from the incumbent or may, at a minimum, cause additional delays whilst new quotes are obtained. A change in incumbent charges part-way through the process will naturally have a knock-on effect for NAVs.