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21 April 2016

Dear Sir,

Consultation - New connections charging, emerging thinking for discussion

Thank you for the opportunity to comment on your emerging thinking on new connection charging.

We think the paper provides a much clearer picture of the future developer charging rule regime and builds on the earlier Ofwat discussion paper from November 2013. We agree with the general direction of the proposed draft charging rules.

In particular we support the view that companies:

- should "*set charges for new connections, but for the charges to comply with [y]our charging rules, and that will sit within the overall policy context as set out in the UK Government's charging guidance*" (Draft Rule 13);
- "*should publish their proposed approach to balancing costs between developers and customers*" (Draft Rule 14) and apply consistent charging principles for different customer classes (Draft Rule 15);
- could "*offer a series of standard fixed charges for different types of common connections (both in terms of on-site and off-site work)"* - possibly with *"post-delivery true-ups*" – and not be limited to only having "*fixed charges*" (Draft Rules 20, 27, 34, 42, noting this becomes a "must" option in 3 of the aforementioned the Draft Rules);
- should have flexibility in the assessment of the need for, and scale of, income offsets (Draft Rule 24 and 25a) and associated asset payments: noting there must be equivalence in approach then adopted (Draft Rules 25b, 25c, 31, 32 and 33);
- should set infrastructure charges, potentially on a zonal basis, that "*reflect the costs of network reinforcement resulting from new development*" (Draft Rules 39, 40, 41, 43b, 43d and 12);
- could "*consider the role of charging structures that send environmentally beneficial price signals*" (No Draft Rule, but could be set as a general requirement for company consideration, being strengthened in the future years).

And we fully support the position that "*achieving a suitable degree of cost-reflectivity needs to be a key concern in the development of charging rules*".

We do have reservations in relation to the following points of administration:

- An Autumn date for final charging rule publication could leave insufficient time to prepare for a significant change in the developer charging regime; and
- Requirements to publish extensive supporting detail on charges that are deemed to be in a contestable market.

Given the tight timescales, we intend to consider these first draft charging rules as being close to final and as such will begin work to embed them to ensure we are ready for the proposed transition early in 2017.

We also believe that companies can only have one charges scheme in place and currently our connection and infrastructure charges are published in this document. We will continue to include our developer charges in our charges scheme to provide full legal protection in their applicability. However, we could also publish an additional separate charging document - essentially a charging methodology statement, as required by Draft Rules 8/16 - the exact legal status of which remains to be determined.

If you would like any more information or details regarding our response please contact David Musco, Tariff Specialist using the following e-mail address, david.musco@yorkshirewater.co.uk.

Kind Regards,

Wendy Kimpton
Acting Head of Regulation

YorkshireWater

Response to Ten Questions

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

We think you have identified all of the key issues with the current developing charging framework.

In our opinion a number of the key issues are created by the arbitrary nature of the Discounted Aggregate Deficit (DAD) approach - which is enshrined in primary legislation - and the unqualified basis of the current infrastructure charge that is contained in our License Condition C. In particular we think it is presence of the mandated income offset (and the equivalent asset payment for water supply) that has then required the Regulator to set a national infrastructure charge to partially negate the impacts of these non transparent financial transfers. We also believe that this complex national rebalancing arrangement is a major contribution to existing current stakeholder dissatisfaction.

One of the biggest issues with the current charging framework relates to the potential lack of cost reflectivity for its constituent parts. This is discussed under section 3.3 of the consultation but is not explicitly identified in table 2, your list of the10 key issues.

Furthermore, in section 3.3.1 of the consultation Ofwat notes that "*a number of studies have found there to be economies of scale in the water sector. Therefore it could be expected that serving additional customers would reduce average costs, ultimately creating a net benefit from water companies having a larger customer base. If developers were exposed to all of the associated costs of connection, such benefit would not be recognised, which could lead to a sub-optimal level of housing development*".

We question the above unqualified economic justification for such financial transfers; namely from the generality of water customers (both existing and new) to developers.

i. Whilst there are major economies of scale in the water and sewerage sector, new housing developments are seeking to join an established network. The more appropriate comparison is between average costs and marginal costs. It is clear that for many companies marginal bulk supply costs are at, or in some cases above, average costs. The claimed reduction of average costs resulting from new development can often be refuted, especially in those companies with water resource constraints in the South East of the country. We also note there is no equivalent additional charge being considered where new housing development is driving up average bulk supply costs and believe that this leads to an inconsistency.

ii. Where there may be a reduction in average unit costs, for example in non-water scarcity areas, the case for sharing these consequential use benefits with developers is not clear. Often it is the generality of existing customers that "*enable*" low marginal costs through previous capacity investments. With an unjustified income offset remaining in place both new and existing customers will then continue to fund an inter-sectoral lump sum transfer to developers. This is as opposed to these customers gaining from lower unit costs via lower water and sewerage bills associated with their higher combined demands.

iii. We believe that whether "*water companies may receive a benefit from having more water bill payers*" is likely to be case specific and may ultimately depend on how these additional demands are fulfilled and whether local distribution unit costs fall as a result of new connections. This would support a more zonal approach to developer charging that would reflect whether such economic benefits are real or imaginary.

iv. Any uniformly applied income off-set or associated asset payment may distort future competitive markets and may give rise to the risk of costly CA98 complaints. A NAV has already raised a related concern, stating that by offering such an income offset to developers and associated asset payments to SLOs (as companies are required to do under the WIA91 and previous Ofwat guidance on this matter (now withdrawn)) – we are raising obstacles to greater competition via insets. This may warrant a complementary section to issue 2 "*risk of double charging*", as some NAVs appear to be concerned that on any given site developers may be being under-charged for services rendered. A potential solution to this problem is suggested under Q8.

v. Domestic water/sewerage demands are driven by individual customers using our services as opposed to the presence of a new house per se. These per capita service demands would exist without new housing development, although possibly at a lower level as average housing strength impacts on average per capita demands. Long term projected population/customer growth may also be partially constrained due to the lack of suitable housing. So if there are any cost reduction benefits to be shared then they could largely reside with new customers of the water and sewerage services, via lower water and sewerage bills, as opposed to property developers via their connection related charges.

We do not think that, in the long term, it should be the responsibility of our existing (or new) customers to automatically subsidise new development, unless the economic benefits are clearly driven by such new developments and the benefit payment can then be offered to all market participants on an equivalent basis.

To this end we think Draft Rule 25a, the need to clearly explain the economic rationale for such income off-sets, is of fundamental importance to the success of the new developer charging regime.

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?

Yes, we agree that this will provide a clear transparent separation of costs. We support the proposal that infrastructure charges should target "*Network Reinforcement*" costs (Draft Rules 12, 40 and 41).

However, we do have concerns about the proposal that infrastructure charges should only relate to Network Reinforcement costs "*that the Undertaker reasonably expects to incur in a given Charging Year*" (Draft Rule 39 and 40). This could lead to sudden abrupt shifts in the charge and create bill stability problems for developers. We would prefer that this charging decision be left with companies who may wish to smooth the costs and associated charges over a number of years, possibly basing the infrastructure charge on forecast zonal reinforcement costs, thereby providing an appropriate incentive to developers to manage their land bank accordingly.

Ofwat has previously stated that infrastructure charges "*should be set at a level that achieves a broad balance between the local system costs associated with connecting new properties and [other] contributions from developers*". We understand this general regulatory position has remained unchanged for a number of years.

If infrastructure charges have traditionally been used by the Regulator as a quasi-rebalancing charge, i.e. to essentially negate the impacts of the income off-set within the DADs calculation, we would expect to see some rebalancing between infrastructure charges (down) and requisition charges (up) as a result of this explicit charge targeting. This will create incidence effects but we believe they are manageable.

On environmental protection the consultation also asked for "*views from stakeholders on the practicality of adopting such charging structures*". We believe that Ofwat should set "*a general requirement for companies to consider the role of charging structures that send environmentally beneficial price signals when developing their charges (as well as promoting overall system resilience*".

Ofwat also identified a potential basis of infrastructure charges as "*an expected litre-per-second demand….so that developers would be able to reduce the charges to which they were subject, through installing more water efficient fittings. This could be adapted for wastewater by using a charging denominator relating to the volume of expected water returned to the sewer (both foul and surface)*". We agree with this outline proposal, but would suggest that it should be a per property charge that is based on a multiple of the Government's 125 litres per person per day planning target (uplifted to account for surface run-off for the wastewater service). This would improve the current basis of the Relevant Multiplier which is based on British Standard BS6700 (which has now been replaced by BS EN 806) which was developed to size internal water pipes, i.e. not external water networks.

You also asked for stakeholder views "*on the removal of condition C and whether or not that would be best done under section 55 of the WA14 or by individual agreement with each company under section 13 of the WIA91*". Infrastructure charges provide over 75% of our developer revenues. But they are currently outside of our control as they are "determined" by Ofwat each year. We conclude that Ofwat should not continue to set/determine the level/structure of infrastructure charges via Condition C. And our initial view is that removal of Condition C should be a relatively uncontroversial proposal that could be quickly achieved under section 55 of the WA14.

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

Yes, we agree – companies should have "*some degree of flexibility in developing their charges*", enabling companies "*to pilot particular charging approaches in their area*".

We support Draft Rule 13, namely that companies should be given full responsibility for developer charges, within appropriate ruled boundaries. We also agree that historic charging provisions should be removed from both the statute book (e.g. the 12 year rule for the DADs calculation) and associated License Conditions (e.g. a national fixed charge for each service that has simply been inflated since 1995, when it was first set at £200 per property).

However, we do observe slightly different regulatory approaches being taken for connection charges and infrastructure/requisition charges. In section 2.2 Ofwat states "*it is our view that there may be scope to increase the level of standardisation into new connection charging*". And in section 5.3 Ofwat notes that "*there could benefit of further sector-wide standardisation*", with the possibility of more prescriptive rules in the future to provide a "*one size fits all*" framework across the sector. The enforced harmonisation policy being discussed for connection charges and potentially other developer charges appears to run contrary to giving full ownership/accountability to companies to develop their own charging approaches - both to reflect their own cost drivers and their customer's needs/preferences. We believe that Ofwat should set rules that target specific charges/approaches that it either explicitly wants in place or does not. This provides appropriate charging rule boundaries without stifling innovation - commonly associated with more blanket standardisation, uniform industry-wide charges and broad-brush rules. In our view simple and transparent developer charging does not necessitate country-wide charging structure/methodological uniformity, although a more common presentational format may assist the national developer community.

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

Yes, we agree - a level playing field can be promoted through increased transparency. We support increased transparency both on developer charges and the basis of any future income offsets/asset payments.

Transparency must be appropriately balanced with commercial confidentiality, as this will always be important in any contestable market. We would welcome a more nuanced approach to the level of charging detail provided that reflects whether the charges relate to a contestable market or not. Indeed we note a subtle difference between Draft Rule 43a and 27a that may address some of our confidentiality concerns. However, there appears to be a clear tension between Draft Rule 16 - that excludes fixed charges from being explained in charging arrangements - and Draft Rule 43a that then includes fixed charges in these same charging arrangement explanations.

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

The value, and impact, of the wastewater asset payment will depend on the value of the income offset and the economic justification for it. And as discussed above, without robust economic justification, we have reservations about the rationale of making such income offsets and associated asset payments on either service.

If on the sewerage service the income offset is, say, set to zero and developers simply pay their preferred provider for their own requisition costs, then no equivalent asset payment would be made available. If this condition is justifiable the drive to create regulatory symmetry between the services could be enabled without material rebalancing consequences. This would then maintain the current position and reduce the "*tension with the UK's Government's guidance that the current balance between contributions to costs by developers and bill payers should be broadly maintained*".

Under the old "arbitrary" 12 year rule of establishing income offsets, the associated wastewater asset payment could range from a few hundred to several hundreds of pounds per property. Ultimately this figure would depend on the expected income profiles over this period - as impacted by average measured bills, assumed inflation/price limits, assumed occupancy levels, the upfront capital cost etc.

Assuming an average asset payment of say £700 per property and around 10,000 new properties connected per year within our region we could be looking at additional annual financial transfers of around £7m pa, over 1.5% of our wholesale wastewater revenues. Given the anticipated guidance from Defra on maintaining the current balance any proposed wastewater asset payments would have had to come from higher developer charges elsewhere. Alternatively the asset payment to the self-lay organisation would have to be paid for by the generality of customers, reducing the costs paid by developers to the same organisation.

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

Yes, we think that providing more information on the basis of our future developer charges will help to avoid the confusion that has been partly caused by previous regulatory and legal interventions in this charging field.

We think the transparency achieved by, for example, Draft Rules 14, 16, 20b, 25a, 27b, 34b, 42b, and 43a is both sensible and proportionate. As explained in our cover letter in terms of information provision we think there may be a need to distinguish between contestable and non contestable charges. We do not think we should be commercially disadvantaged in any competitive market.

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?

We do not believe any further information should be requested by the Regulator. We would suggest that the extent of the proposed information provision for what is a partly contestable market is proportionate.

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

We think the draft charging rules provide a good framework within which companies can look to innovate. In particular we think the flexibility as to whether income offsets and asset payments are legitimate (Draft Rule 24) is both pragmatic and more cost reflective. And we think the need to explain departures from the current charge balance provides some guarantee of bill stability, without automatically preventing the potential for future rebalancing (Draft Rule 14).

We believe that the rules about developer charging must also include those that can be made under section 143B of the WIA 1991 (i.e. infrastructure charges). To locate them in a separate broader 143B rules document could lead to some stakeholder confusion. In our opinion the rules that relate to developer charges should remain whole.

We have one specific suggestion.

Despite our reservation about the country-wide legitimacy of income offsets we recognise these financial transfers will, as a consequence of Draft Rule 14, continue to occur for some time. We agree with Draft Rule 14 – this continuation of the status quo will provide for bill stability for all customers. And we would agree that the income offset should be wholly transparent (Draft Rule 25a) so that all customers can assess the value of, and justification for, it.

But we would suggest that the income offset, as explained in Draft Rule 24, should <u>not</u> be explicitly tied to requisition charges as described in Draft Rule 18.

We would suggest the income offset should be used in conjunction with infrastructure charges. This would assist in developing a level playing field in the self-lay market; there would be no potential for competitive distortions in requisition charges associated with income offsets and/or asset payments. And where justified the income offset could be used to support infrastructure charge reductions, notably where developers fulfil specified environmental sustainability objectives or locate where there is spare local network capacity.

In other words the income offset could possibly underpin and justify material infrastructure charge reductions to incentivise the associated cost saving behaviour re the installation of SUDs, water efficient devices etc. In the short term the income offset could also be used to smooth any incidence impacts associated with the charge targeting discussed in Q2.

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 consider that it is appropriate – we think that such a requirement would be an area where the industry would benefit from the associated harmonisation.

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

We think the potential charging rules presented for discussion in Appendix 1 represent an excellent start position.

Ofwat states that it "*intends to publish final rules in autumn 2016*", further proposing "*to align the process for new connections charging with wholesale charging because of the interlinkages*".

We would hope that the formal draft charging rules consultation will be held soon after publication of the forthcoming draft Defra charging guidelines (expected end of April). And that, given comment on the current pre-draft rules, these draft charging rules will be close to being considered as final at this second more formal consultation stage. The final charging rules for April 2017 could then be in place by the start of autumn 2016, at the very latest.

Without early autumn (September) or even late summer (August) publication of the final rules and some indication that the draft charging rules to be published for consultation in the summer will be close to the final autumn ones, the time being allowed for companies to actual develop a wide range of different charges and associated supporting methodologies is extremely short.

This is particularly so given the Regulator's recent information request (IN 16/02) that companies "*publish indicative wholesale access charges for 2017-18 by October 2016*". Unless the final charging rules remain largely unchanged from draft the proposed interlinkage between wholesale and connection charges will not be possible at this juncture, and wholesale charges for 2017 may then be very indicative.

Even with an early autumn publication (September) of the final charging rules we will then only have 3 months (October, November, December) to develop a wide range of new charges/methodologies and 3 months (January, February, March) to transition them.