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Charging
Ofwat
21 Bloomsbury Street
London
WC1B 3HF.

Sent by email only to: charging@ofwat.gsi.gov.uk

Dear colleague

Response to Ofwat's Consultation on New Connections Charging "the Consultation"

We welcome the opportunity to respond to the Consultation. Our responses to Ofwat's specific consultation questions are provided in an Annex but we set out in this letter an overview of our thinking.

As you will already be aware, IWNL operates as a New Appointee. We have long been concerned that arrangements for new connections charging restrict and distort competition for the installation and ownership of new water networks. We are therefore pleased to see greater recognition of this in the Consultation and the inclusion of some proposals that could start to level the playing field.

In particular:

- We welcome your proposal that there should be a clear separation of charges for contestable and non-contestable works and greater transparency about what services are being provided in return for each element of the charges. The approach of separately identifying charges for contestable and non-contestable work is one that has been in place for years in the gas and electricity markets and which has generally worked well. It is likely to enhance competition by allowing customers to make a better comparison of offers and is likely to result in more cost-reflective charges over time.
- In tandem with the explicit separation of charges for contestable and non-contestable work, we agree that requisition charges should be limited to site-specific work and that any reinforcement costs should be included only in infrastructure charges. In addition to reducing the perceived risk of double-charging, it ought to reduce the risk of discrimination against SLOs and New Appointees since there should be a single consistent set of charges levied regardless of who completes and/or owns the works on-site.
- We strongly favour the suggestion that any income offsetting should apply against infrastructure charges rather than requisition charges so that everyone

receives the same discount regardless of who constructs and/or owns the on-site network. Adopting this approach should remove one of the most significant obstacles to competition by New Appointees.

The measures proposed are likely to enhance both competition by SLOs for the construction of contestable works and by New Appointees for the ownership of the same works. Facilitating competition against incumbents at both levels has been shown in gas, electricity and telecoms to result in new market entry and enhanced investment, innovation and improved customer service. In short, it ought to lead to real benefits for customers.

We are, however, concerned that you ultimately do not go far enough with your intended proposal on income offsetting. We note that you are not proposing at this stage to commit definitively to requiring income to be offset against infrastructure charges but only to "*keeping [it] under review*" and, moreover, that you do not contemplate introducing any such requirement until April 2020. Although we appreciate that there is an interaction with price controls that needs to be managed, we consider that the most appropriate solution is to make a (simple) amendment to the existing price controls. Further, and in any event, there is certainly nothing to stop Ofwat reaching a firm conclusion now that the industry should move to the new approach in due course. We cannot see why it should be merely kept "*under review*".

If you do decide to keep to an April 2020 implementation date, notwithstanding our comments above, we consider it important that Ofwat should in the meantime provide much firmer direction to incumbents on how to apply income offsetting so as not to prejudice New Appointees. The current approach to income offsetting is, as we say, a significant obstacle to competition and if it is allowed to continue it is unlikely that competition will begin to flourish until at least 2020 and it may never succeed at all if companies leave the market in the meantime. We have suggested some additional wording for the draft rules to try to improve the situation during any interim period.

More broadly, whilst the proposals in the Consultation will start to level the playing field, there are other obstacles to competition by New Appointees that need to be addressed in parallel. Two such issues are referred to in the Consultation but are said to be outside the scope of the new connections charging rules. We do not seek to challenge this assessment, but ask that Ofwat provide support and guidance on how the two issues will be addressed. The issues we are referring to, mentioned on page 15 of the Consultation, are cost reflective boundary charges for New Appointees and timing (the time it takes incumbents to respond to requests for connection to their network). Our high-level thoughts on these two issues are set out below.

Cost Reflective Boundary Charges for New Appointees

As you will be aware, we have been complaining for a long time that the bulk supply and discharge charges imposed on us by incumbents are not cost-reflective and often impose a margin squeeze on us, foreclosing competition. We have raised this concern with several undertakers and we are finally beginning to see some progress. In particular, Severn Trent has now published a statement of significant change to

wholesale charges indicating its intention to publish a New Appointee-specific tariff for implementation in April 2017, which it says will ensure a margin for an equally efficient operator owning and operating an on-site network as a New Appointee.

Our view is that all other undertakers should follow suit, providing a New Appointee-specific tariff by April 2017. Undertakers are already under a duty to offer cost-reflective charges to all customers and plainly do not do so for New Appointees. The existing conditions of the instruments of appointment also allow undertakers to treat New Appointees as a separate class of customer and to set separate tariffs accordingly.

The Consultation indicates that Ofwat intends to "*explore with stakeholders whether and how it might be appropriate for us and/or companies to help address*" concerns about bulk supply and discharge pricing but gives no further detail about what you might have in mind or the timing for any intervention. Whilst we welcome the involvement of Ofwat, we are concerned that incumbents may rely on the possible future intervention of Ofwat as a reason not to make any changes now. Indeed, we have seen exactly that with one incumbent that has refused to explore the possibility of a New Appointee-specific tariff because of the possibility that Ofwat may shortly set new wholesale charging rules anyway.

We would ask you please to clarify, with specific reference to the position of New Appointees, that the possibility of future Ofwat intervention does not excuse incumbents from complying with the requirements of their instruments of appointment and of competition law in the meantime. As such, incumbents should consider the possibility of New Appointee-specific tariffs without waiting for a direction from Ofwat requiring them to do so.

Timing

IWNL has reached agreement with several water undertakers to apply their service levels for developer requests for connection to their networks to similar requests from New Appointees. We are now working with Water UK to formally apply this standard across the industry. We urge Ofwat to encourage Water UK to progress this initiative expeditiously.

Ofgem addressed very similar obstacles relating to response times in the electricity and gas sectors. Following formal action by the regulator, incumbents were instructed to 'remove themselves as far as possible from the process.' This has resulted in a 'self-serve' model. Suitable accredited parties can access network records and design their own connection points for standard sites, unhindered by the incumbent. This enables competitors to be in charge of their own destiny by providing a complete quote to developers, inclusive of the off-site point of connection. We have demonstrated this to Ofwat, Defra, Water UK and a number of water undertakers. Again we urge Ofwat to encourage the roll out of a self-serve model through Water UK.

Progress has been made on bulk tariffs for new appointees and on response times by incumbents but more needs to be done. We are keen to work with Ofwat and the

industry to create a clear framework and agree standard processes. Such steps will complement the new connection charging rules and create a truly competitive market. Failure to address the two other issues will mean that the charging rules do not achieve their goals.

As always, we would be happy to discuss our response in more detail with you should this be of assistance. We are content for you to publish the whole of this letter and the attachment; we do not wish to claim confidentiality over any of the contents.

Yours faithfully

Mike Harding
Head of Regulation

Appendix 1 response to Ofwat Questions

Q1 In light of our updates and clarifications, do you agree that we still retain the key features and approach of our March proposals?

We believe the key features and approach of Ofwat's March proposals have been retained.

Q2 Do you agree with our updates and clarifications to our proposed rules?

We agree that the updates and clarifications are an improvement to the rules set out in the March proposals.

As Ofwat is aware, we have significant concerns with the current charging framework as applied by incumbent undertakers. This results in competition in the connections market being distorted against New Appointees in many instances. This approach, together with the bulk supply and discharge tariffs offered to incumbents, forecloses much of the connections market to New Appointees.

In the Executive Summary of the March proposals Ofwat stated:

> *"…our emerging thinking so far is to….help promote a level playing field, for alternative providers that wish to compete with water companies to provide new connections by requiring equivalent charging for equivalent services".*

We welcomed this sentiment but felt it was not reflected in the main body of the March proposals or in the draft rules accompanying the March consultation.

We are pleased to see that the objective of a level playing field is now discussed much more prominently in the Consultation. We particularly welcome Ofwat's comment that:

> *"In our view, companies' system of charges, income offsets and asset payments must be set and applied in such a way as to provide a level playing field".*

We still feel, however, that the draft charging rules could and should go further in this regard. It is, of course, only the rules that create directly enforceable obligations.

Whilst proposed rules 20 and 21 (as set out in Appendix 1 of the Consultation) are a significant improvement on the March proposals we think they could be more explicit. For example, it should be made clearer that New Appointees are a "*class of customer*" and that "*Consistent principles and approaches…*" means that connection charges are to be determined on the same basis where the water and/or sewerage undertaker owns the on-site assets as where it does not.

Q3 Do you agree that offsetting the infrastructure charge, rather than requisition charge, has merit? If so, when and how should this change be brought about?

We strongly support the suggestion that any income offsetting should be restricted to infrastructure charges and not requisition charges.

Our experience shows that the current approach of offsetting income against requisition charges can – and often does – entirely foreclose competition by New Appointees. New Appointees often cannot match the asset payments offered by incumbents there is effectively a level of cross-subsidy from existing customers that exists only where the incumbent constructs or adopts the on-site network.

Making the same discount available to all, by taking account of income in the infrastructure charges payable by everyone, should remove this obstacle to competition.

In these circumstances, it is not clear to us why Ofwat only proposes to keep this option "*under review*" (page 28, third bullet). We cannot see anything stopping Ofwat from adopting a more definitive position and it would both make a much more positive statement and allow undertakers to prepare better if Ofwat did so.

It may be that Ofwat's position in this regard is linked to its conclusion that it should not make any change before the next price control comes into force in April 2020. There may perhaps be a concern about the possibility that circumstances may change before April 2020 and/or a concern generally about making any decisions on elements of the price control in isolation without considering everything in the round. Whilst we can see why these might be valid concerns in other circumstances, we cannot see how they can apply to this particular proposal. There is nothing about the proposal that could be affected by subsequent developments or that depends on how the rest of the price control elements are designed.

Further, we cannot see why Ofwat sees the need to wait until April 2020 to make this change. We appreciate that it would not work to change the rule now without adjusting the existing price controls but the change needed to the price controls is a very simple one that ought to be wholly uncontroversial. All that is needed is some drafting to indicate that:

- Revenue for the purposes of the price control will include the full amount of infrastructure charges that would have been levied absent any income offset; and
- Any income offset applied to infrastructure charges shall be treated as a cost.

Such a minor complication ought not to be allowed to delay implementation of a reform that could be so positive for competition. We hope that Ofwat will reconsider its position on timing and will look to implement the new approach from April 2017.

In this regard, we note that one of the benefits that Ofwat identifies with offsetting against the infrastructure charges is that it will "*potentially improve the stability of charges by reducing the increase in infrastructure charges brought about by our new rules*". This will only be the case if the new offsetting rule is introduced in April 2017, at the same time as the other changes are implemented.

If, contrary to the above, Ofwat decides to maintain its position on timing we would at least hope to see some concrete steps by Ofwat to improve the current situation in the meantime. Competition from New Appointees is likely to continue to flounder as long as the current approach to income offsetting persists. It needs to be clear to undertakers that must avoid discriminating against New Appointees (or SLOs).

We have suggested some changes to the draft rules in our response to Q6 in the event that the April 2017 date is not achieved.

Q4 Do you have comments on our proposed approach to implementing our rules?

We agree that the rules should be implemented from April 2017. As indicated in our response to Question 3, we are concerned about the possibility that the change in offsetting rules may only be implemented later.

Transitional Arrangements

Binding agreements entered into before the publication date of the new charging rules on the basis of the old arrangements should remain valid after the introduction of the new arrangements.

There should be customer flexibility as to which charging rules apply where agreements are entered into between the publication date of the charging rules and the date from which the new charging rules take effect and where the services covered by the agreement will be provided after the date from which the new charging rules take effect.

We understand that the above reflects what Ofwat is proposing (albeit that the connection must be provided before April 2022 if the old rules are to be applied).

Q5 Do you agree with the approach we have taken to our draft impact assessment? Can you provide quantitative figures in terms of the potential benefits or costs? Is there anything we have missed?

We agree with the general approach.

We note that Ofwat states in its Appendix 4 (on unlocking competition):

"We consider that [the] current charging framework presents arrangements that may not ensure a level playing field".

We are of the view that there is no doubt that the current charging framework as applied by incumbent undertakers results in charges that have the effect of distorting the market for competition in connections with the result that over 90% of the current new connections market is foreclosed to competition from new appointees. This is either because:

- incumbent undertakers may use a different charging approach to determine net connection charges where they will either provide or adopt, than they will use when determining the connection charge to new appointees; or
- the tariffs levied to new appointees are set at a level such that the new appointee is unable to earn a relevant margin if it were to charge the its end customers same price as an incumbent would to equivalent end customers; i.e. a margin squeeze exists.

Although the changes proposed in the Consultation will not remove all the existing obstacles to competition, they do have the potential to significantly improve the situation. At the moment, we estimate that New Appointees account for just 2% of all new development networks so even a slight improvement in the conditions of competition could dramatically increase the impact of New Appointees.

We note Ofwat's reference to papers by Rowson, and by Foellmi and Meister on the potential benefits in the water sector. Additionally, there is a much broader body of evidence that demonstrates the benefits of competition in network industries.

Q6 Do you have any comments on the drafting of our new connections rules?

Whilst the Consultation itself establishes a clear objective to create a level playing field for New Appointees, we believe that the draft rules do not reflect this as well as they could.

- Rule 20 states that consistent principles and approaches must be applied to charges for different classes of customer and notes, for the avoidance of doubt, that "*this includes the calculation of charges for Non-contestable Work, whether or not a person other than the undertaker is carrying out Contestable Work.*" We appreciate that the intention here is to prohibit incumbents from offering charges for non-contestable work that are less favourable where a developer chooses to use a SLO and/or New Appointee to construct or own and operate its on-site network (as appropriate). Unfortunately, we do not think the wording works as currently drafted. This is because: (i) there will not necessarily be a different class of customer for

a connection where using a SLO or New Appointee – the developer might still be the customer in both cases; (ii) a New Appointee is still an undertaker; and (iii) the significance of involving a New Appointee is less around who "carries out" contestable work than around who adopts the assets resulting from the work. We would suggest redrafting Rule 20 as follows:

"*Consistent principles and approaches must be applied to the calculation of charges for different classes of customer. Without prejudice to the generality of the foregoing, an Undertaker must apply the same approach to calculation of its charges for Non-contestable Work regardless of who carries out any Contestable Work and regardless of who adopts any assets provided as a result of Contestable Work. For the avoidance of doubt, this rule is intended to prohibit discrimination by Undertakers against New Appointees and anyone competing with the Undertaker to carry out Contestable Work.*"

- Rule 21 is also too narrow because it could be read as merely requiring undertakers to promote effective competition for **the construction** of Contestable Work (i.e. the market in which SLOs are active). New Appointees compete to own and operate the assets provided as a result of Contestable Work. We would propose that Rule 21 be redrafted as follows:

  "*Charges (including any Income Offsets) and any Asset Payments must be set in accordance with the principle that they should promote effective competition for Contestable Work and for the adoption of any assets created through Contestable Work.*"

If Ofwat does not require income offsetting to be limited to infrastructure charges with effect from April 2017, we consider that further amendments will be needed to the rules to ensure that the existing unfair arrangements are not perpetuated. We would propose the following amendments:

- We would remove the word "*and*" at the end of sub-rule 27(a), replace the full stop at the end of sub-rule 27(b) with "*; and*" and add a new sub-rule 27(c) as follows:

  "*must not unduly discriminate against the use of a New Appointee by a Developer.*"

- We would remove the word "*and*" at the end of sub-rule 30(b), re-number sub-rule 30(c) as sub-rule 30(d) and add a new sub-rule 30(c) as follows:

  "*The methodology for the calculation of any Income Offset must not unduly discriminate against the use of a New Appointee by a Developer; and"*

- A sentence should be added at the end of rule 39 as follows:

"*Any Asset Payments must be applied so as not to unduly discriminate against the use of a New Appointee by a Developer.*"

Our other more minor comments on the draft rules are as follows:

Rule 5(i)

The second paragraph of the definition of "Fixed Charges" appears to be incomplete. We think the last sentence should probably say

"*Furthermore, undertakers may offer more than one Fixed Charge in charging for a service provided in accordance with the present rules (for example, by differentiating between different geographic* ***zones****)".*

Rule 5(j)

Rule 5(j) defines "Income Offset" in terms of *"…revenue likely to be received by the relevant undertaker in future years for the provision of … supplies of water".* The use of term '*provision*' implies it is, or could be, the revenue from the bundled service*.* Given the development of retail competition for non-household customers (and the possibility of this being extended to the domestic market) we query whether this is the right term to use. We believe the Income Offset should only apply in respect of revenues for the '*conveyance'* of water; e.g. Income Offset should not include revenues from the retail component of water provision.

General

"New Appointee" is a defined term; its use in the rules should be capitalised to be consistent with the use of other definitions. The same is true for the use of the term "*Undertaker*" in the rules.

Q7 Do you have comments on the draft changes to the charges scheme rules?

We do not have any comments on the draft changes to the charges scheme rules other than to note that the definitions in the charging scheme rules are a mix of capitalised and lower case terms. This differs from the Draft Charging Rules as set out in Appendix 1 of the Consultation where all definitions are capitalised. We suggest that a single consistent approach is adopted for both. Our preference is for capitalised terms.

Q8 Do you have any comments on the drafting or our proposed licence modification, including the wording of the illustrative example?

No comments.