

# New connections charging - consultation

## Southern Water's Response

August 2016



## **Southern Water's response to Ofwat's consultation on new connections charging**

### **Overview**

We welcome the opportunity to contribute to Ofwat's consultation on new connections charging.

We believe that greater clarity, consistency and transparency in the setting of developer charges has the potential to deliver benefits to the developer community and could also lead to a reduction in the number of inquiries into developer charges.

Although we believe Ofwat's suggested timetable to be broadly achievable, we recognise that the development and delivery of a new charging model in such a limited timeframe will carry risks. Therefore the processes adopted by water companies will need to be agile enough to adapt to future learning from our customers, developers and the industry, but sufficiently robust initially to avoid numerous subsequent changes which could frustrate customers.

### **Responses to consultation questions**

#### **Q.1. In light of our updates and clarifications, do you agree that we still retain the key features and approach of our March proposals?**

We agree that the key features and approach, as set out in the March proposals, appear to be a sound logical step towards greater clarity and transparency in developer charges. We also agree that the current balance of charges between developers and customers should broadly be retained through ensuring charges to developers as a class reflect the costs of serving that class of customer.

We agree that there are benefits from companies publishing their charges in a single, consistent document. This increases transparency and certainty for developers, although it does not address the issue of consistency between different company approaches to setting charges. We believe there is a demand from developers for greater simplicity and consistency between companies in the sector.

#### **Q.2. Do you agree with our updates and clarifications to our proposed rules?**

Generally we agree that Ofwat's proposed updates and clarifications go some way to providing a greater degree of transparency and consistency in setting Developer charges, whilst retaining a degree of overall cost reflectivity in the charges themselves.

More detailed comments on each of the principles are provided below:

#### *Fairness and affordability*

In terms of allowing companies to develop their own approach to setting infrastructure charges, we see the benefit in allowing companies to develop charges which best reflect areas of significant cost differentials, e.g. through regional / zonal charges that reflect different capacity or regional issues. We also strongly welcome the continued opportunity for companies to develop innovative approaches to promoting environmental initiatives such as Southern Water's variable infrastructure charge to promote water efficiency.

However, we are concerned that, without all companies adopting a standardised approach to infrastructure charging there may be the risk of a high degree of variation in the way in which the infrastructure charges are set, with the result that the charges may not be directly comparable for developers; one of the key issues that Ofwat is trying to address.

We advocate a move towards greater standardisation through the implementation of a single charging methodology for the infrastructure charge. This would provide a much greater level of clarity and consistency of approach for developers. Given that a large number of developers are national players, having a national approach to infrastructure charging will allow for direct comparisons of companies' charges.

#### *Level playing field*

Ofwat has stated that companies should apply their charges, income offsets and asset payments in such a way as to "*promote effective competition*". We would question whether it is in a company's gift to actively promote competition through their charges. However, if, by "promoting competition", Ofwat intend that companies should set clear, transparent, consistent, and cost reflective charges that allow developers to form an understanding of the overall expected level of charges ahead of undertaking any development and to ensure a level playing field between providers where competition exists, then we would support this principle.

#### *Transparent and customer focussed*

We agree that companies should provide both a greater level of transparency on their charges as well as provide a clearer picture of what activities and costs their charges are intended to recover.

Whilst we accept that further guidance will come from the forthcoming consultation on Regulatory Accounting Guidelines for the 2017/18 reporting year, we believe that clarity on cost allocation is needed as soon as possible so as to enable companies to move forward with the design and implementation of the new infrastructure charge. For example, in previous determinations, Ofwat have disallowed a share of corporate overheads to be included in developer charges. We think that it is important that these costs are shared between customers and developers, therefore clarity on this, and other issues would be strongly welcomed. As such we welcome Ofwat's commitment to work collaboratively to provide greater clarity here and urge Ofwat to commence this work as soon as practically possible.

We agree that the guidance on how companies should engage with their customers on developer charges should be a non-prescriptive process. We believe that such engagement should take place as part of our ongoing relationship with developers rather than just a one off process at the time of setting charges.

#### *Stable and predictable charges*

Ofwat's proposal that companies should report and balance their charges over a rolling five year cumulative period seems sensible. This will enable companies to provide developers with greater transparency and clarity in the level of the charge and retains the principles that charges should be cost reflective overall.

We accept that reporting such costs and revenues through the APR appears to be a sensible approach. In terms of what might be an acceptable threshold to apply on variances between costs and revenues, given that there is inherent uncertainty in forecasting the number of new connections, we believe that this figure should be reasonably high, in the region of 10-15% over a rolling five year period

Given that that this is a significant change in the approach to setting infrastructure charges and with such charges to be implemented in a relatively short timeframe, there will be a degree of learning by doing by companies and developers in the charge setting process. With this in mind, we do not believe that establishing specific ODIs in relation to under / over recovery of charges is appropriate at this time. ODIs should be focused on incentivising companies to deliver the priorities of end-user customers, not on business-to-business relationships. We believe that there are more appropriate regulatory mechanisms to ensure that an accurate reporting and recovery process is in place and that any over or under recovery of charges are appropriately dealt with.

**Q.3. Do you agree that offsetting the infrastructure charge, rather than the requisition charge has merit? If so, when and how should this change be brought about?**

We agree that this approach has merit and should be applied when the new infrastructure charges are brought in, in April 2017. We recognise that this might alter the balance of charges between developers and other customers. However, for Southern Water the impact will be minimal at this time given the relatively low levels of self lay in our area.

**Q.4. Do you have comments on our proposed approach to implementing our rules?**

The overall approach to implementing the new rules appears sensible.

We reiterate our concern made in response to the previous consultation that the April 2017 timeline will be very challenging to meet especially given the lack of clarity provided to date as regards appropriate cost allocation for developer charges. Implementation to this tight timescale therefore carries a greater risk, which all parties must recognise.

**Q.5. 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?**

The approach looks sensible. We have not yet had the opportunity to assess, in full, the potential benefits and costs of the proposed approach, and will be undertaking our own analysis of the impact of different charging structures as part of our process to establish the new infrastructure charge.

**Q.6. Do you have any comments on the drafting of our new connections rules?**

Overall, we found the drafting of the charging rules to be complex and legalistic. As you are aware one of the biggest challenges of the current arrangements is the complexity of the rules relating to charging developers, which leads to an unnecessarily high level of charging disputes and challenges.

The content of the new charging arrangements goes a long way to addressing some of these challenges, but this clarity is not always reflected in the drafting of the rules. We recognise that in some cases this is because definitions etc have been extracted from the Water Industry Act, but we urge Ofwat to review whether there are opportunities to make the charging rules far easier for all stakeholders to understand.

In terms of the substance of the rules, we have the following comments:

- (i) The definition of “Network Reinforcement” should include reference to on-site and off-site storage as well as sewers and pumping stations.
- (ii) The principle of maintaining the present balance of charges between developers and other customers (paragraph 19) would be better expressed in terms of ensuring that charges remain reflective of the underlying costs of providing the relevant services. This would allow for movements in the level of activity and underlying costs to be reflected in charges while being consistent with the Defra charging principle. It is also more straightforward in terms of the drafting – it is not clear what maintaining “the present balance” actually means in practice, since it is not linked to a particular point in time.
- (iii) The requirement to “promote effective competition” in paragraph 21 places an unreasonable obligation on the charges. We believe the proper requirement is to set charges which do not distort or act as a barrier to effective competition and the rules should reflect this formulation. It is not clear how we could demonstrate that our charges actively “promote” competition, as opposed to ensuring a level playing field between parties.
- (iv) Ofwat has accepted in previous determinations that upsizing of infrastructure is based on standard available pipe sizes, meaning that in some cases the next available pipe size will provide some additional capacity. Paragraph 28 should reflect this principle. As currently drafted it is likely to lead to challenges from developers who would expect an apportionment of costs in respect of any incidental excess capacity.
- (v) The timescale of companies’ obligations to be met from the date of the application to delivery of network reinforcement (if required) needs clarification. We advocate a timing allowance to be made for holistic solutions to be developed if there are multiple development applications in a region.

#### **Q.7. Do you have comments on the draft changes to the charges scheme rules?**

We have only one minor comment on the charges scheme rules.

The requirement to balance charges over a five year period must be subject to some leeway (as per question 3 above) or this would place an unreasonably precise burden on undertakers. This tolerance needs to be reflected in the charges scheme rules.

#### **Q.8. Do you have any comments on the drafting of our proposed licence modification, including the wording of the illustrative example?**

The proposed approach looks sensible.

Should you have any queries regarding our response, or would like to discuss any aspect of it with us, please contact our Head of Economic Regulation, Nikki Deeley, on 01903 272336, or by email [nikki.deeley@southernwater.co.uk](mailto:nikki.deeley@southernwater.co.uk)