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Dear Sir or Madam

New Connections Charging – Consultation

We welcome this opportunity to respond to Ofwat's "New Connections Charging – Consultation", as we recognise that connections charges have long been the subject of concern for developers and companies alike. Subject to resolving the points below, we agree that the implementation of a new charging regime provides an opportunity to help developer customers in a number of ways including allowing greater clarity in advance on connection charges, introducing a more flexible infrastructure charge, and addressing the perception of double-counting between infrastructure charges, and requisition charges.

We have, however, three significant concerns about the proposed charging arrangements:

a) the interaction of the new regulatory mechanisms with the totex mechanism and revenue cap risks penalising companies that invest ahead of need;
b) the implementation timetable appears to us to be unnecessarily ambitious and does not allow sufficient time to mitigate the incidence effects on those developer customers and Self-Lay Organisations ("SLOs") that could be materially worse off under the new arrangements; and
c) it may not be possible to define "Fixed Charges" for the most complicated connections work.

We provide more detail on each of these points below.

(a) The interaction of the new regulatory mechanisms with the totex mechanism and revenue cap will penalise companies that invest ahead of need

One of the stated aims of the new rules is to "*remove any disincentive to invest ahead of need*".[1] We note, however, that if a company was to bring forward investment, it would incur higher totex that year. As we have explained previously, this higher totex would cause the company to face a material totex penalty under the totex mechanism, unless it collects the extra revenue from

[1] "*New connections charging – consultation*", Ofwat, 27 July 2016, Page 25.

developers. At the same time, it would be unable to recover additional revenue to compensate because of the wholesale revenue caps. Companies would, therefore, be materially worse of if they invest ahead of need. We would encourage Ofwat to resolve this point before proceeding, by confirming that the additional revenue required by companies to counteract this penalty will be allowed as “extra revenue” in line with the proposal on Page 47 of Policy Chapter A3 of FD14.[2]

(b) The proposed implementation timetable is too ambitious

The proposed changes are material, and will replace actual cost connection charges, with new “Fixed Charges” that developers can calculate based on ratecards published by companies. As the consultation acknowledges, this will create winners and losers. The implementation timetable may not allow companies enough time to model the new charges and identify who the losers will be, or the extent to which they become worse off. It will not be possible, therefore, for companies to consult with all those developers and SLOs impacted, to identify whether or how the adverse impacts could be mitigated.

A corollary of an unnecessarily tight implementation timetable is that companies may only have time to develop high level “one-size-fits-all” type charges for the first year. Such charges may not secure many of the benefits that the new regime is intended to deliver (not least because they may have to change materially for the second year of operation).

Given that there are a large number of development projects in their planning stages, we believe that developers and SLOs should be given at least 8 months’ notice of the changes before the new rules come into force.

(c) Complex connections work

Whilst ratecards can be developed that will define “Fixed Charges” for most connections work, it may not be possible to derive “Fixed Charges” in advance for the most complicated connections work. In line with the gas sector, and as we set out below in response to Question 4, we believe that (at least for the transition period) it should remain open for companies to price the most complicated connections work on a bespoke basis.

We attach more detailed responses to the specific consultation questions.

Yours faithfully

Nick Fincham
Director of Strategy & Regulation

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[2] This states that “…*if demand for connections is unexpectedly high then we would nevertheless consider allowing extra revenue to compensate for the loss of price control revenue on a case-by-case basis* … ”.

Thames Water's detailed response to Ofwat's consultation on New Connections Charging

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 agree that the proposals have the potential to bring benefits, and reduce the need for companies to use planning conditions to ensure that developers give appropriate consideration to the hydraulic impacts of their developments. We have, however, a material concern (which we highlighted to Ofwat in our response to the March 2016 proposals) that the implementation timetable is unnecessarily tight, and two additional comments.

Implementation timetable

The proposed changes are material, and will replace actual cost connection charges, with new "Fixed Charges" that developers can calculate based on ratecards published by companies. As acknowledged in the consultation, this will create winners and losers. The implementation timetable does not allow companies enough time to identify who the losers (or winners) will be, or the extent to which they become worse off. It will not be possible, therefore, for companies to consult with all those developers and SLOs impacted, to identify whether or how the adverse impacts could be mitigated.

A corollary of an unnecessarily tight implementation timetable is that companies may only have time to develop high level "one-size-fits-all" style charges for the first year. Such charges cannot be properly cost reflective, and will not secure many of the benefits that the new regime is intended to deliver (not least because they may have to change, materially for the second year of operation). As a consequence, for any given development these charges are likely to either overstate or understate the true costs. Where they understate the costs, it will make it harder for SLOs to compete. Where they overstate costs, developers will be worse off. It would be better if companies were allowed sufficient time to design, model and consult on more detailed cost reflective charging structures.

Additional comments

Our additional comments are:

- As drafted, the proposed rules require companies to make fixed charges applicable "*at the outset*" of development.[3] This term could be construed to refer to land acquisition stage, the initiation of detailed design, the start of construction on site, or indeed, other points in time. It will be important that the final wording makes the meaning clear.
- The statement that "*companies would be financially neutral to such changes…*" [4] is not correct. Whilst the single-till price control ensures that the price control revenue does not change, the company is affected because totex is defined as being costs less developer

[3] "*New connections charging – consultation*", Ofwat, 27 July 2016, Page 53, Rule 5(i).
[4] "*New connections charging – consultation*", Ofwat, 27 July 2016, Page 33.

contributions. There will, therefore, be an impact on companies' allowed totex under the totex mechanism.

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

The consultation clarifies how the new rules will operate, and provides further details of the specific mechanisms that will apply. Whilst we expect that these mechanisms will operate as intended in the majority of scenarios, we are concerned that there are at least two scenarios where there may be unintended consequences, as follows:

- We welcome new rules that allow companies to balance charges with infrastructure investment over a rolling 5 year period rather than a fixed AMP cycle. However, if future housing growth is lower than forecast, companies will be required to recover the cost of early investment from a smaller number of connections than envisaged. This will increase the charges to developers, potentially making new developments less economic at a time when housing growth is declining.
- It is not always the case that companies are able to recover the full cost of service connections to new dwellings under the existing arrangements. The requirement to maintain the current balance of contributions could perpetuate the extent to which the current balance isn't cost reflective. This, in turn, may perpetuate any circumstances where SLOs are unable to compete.

In addition, it would be helpful if the new rules made it clear that companies are not restricted from offering more than a 100% infrastructure charge discount in circumstances where a developer is prepared to provide environmental protection which benefits more than just their development (i.e. a developer is prepared to benefit another development underway, or one which is likely to start in the future).

Finally, we note that Rule 43 uses the term "*deposit*".[5] For the avoidance of doubt, we note that the term "deposit" is not strictly correct, as it can have a specific legal meaning which would not be appropriate here. As we understand it, the rules should refer to "cash collateral" rather than "deposit".

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 understand the advantages of infrastructure charges taking account of the benefits that additional connected properties bring, and we would welcome this change.

With respect to the timing of this change, as we noted above, the implementation timetable is unnecessarily tight, and our preference would be for implementation no earlier than the second half of 2017.

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[5] "*New connections charging – consultation*", Ofwat, 27 July 2016, page 61, Rule 43.

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

As noted above, we believe that the implementation timetable may be too challenging to allow the winners and losers to be identified in time to mitigate potential adverse consequences.

We also note that, in the gas sector, due to the complex nature of some developments, the ratecard prices only apply to 80% of gas connections revenue.[6] This is sometimes referred to as "the 80/20 rule". To the extent that a proportion of developments are too complex to allow the cost of gas service connections to be priced using a Fixed Charge/ratecard approach, a similar proportion may also be too complex for water or sewerage connections to be priced that way. We believe, therefore, that at least for the transition period, the Fixed Charges should not be required for the most complex connections, i.e. those with one or more of the following characteristics:

- over 0.5km in length;
- over 250mm diameter pipework;
- waste rising mains;
- rail & tube line crossings;
- river & canal crossings;
- syphons;
- designated land;
- archaeology; or
- contaminated land.

Alternatively, the approach from the gas sector could be adopted during the transition period, requiring only 80% connections revenue to be derived via Fixed Charges.

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?

The high level impact assessment concludes that broadly maintaining the balance of contributions has no negative impact on the connections market as a whole. It would be helpful to stakeholders if the final impact assessment considers the potential impact on individual connections customers, particularly those identified as winners and losers. We highlight below some further areas that could be included in Ofwat's final impact assessment:

- the interactions between the new regulatory mechanisms, the totex mechanism and the wholesale revenue cap, that penalise companies that invest ahead of need;
- the extent to which SLOs will be prevented from competing for some large or complex connections where Fixed Charges derive a charge which is below the actual cost;
- if the most complex developments are also required to be priced using a ratecard, the extent to which this will lead to an increase in complaints (NB: this would not be needed if

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[6] IWNL Presentation to Infrastructure Policy Group, Water UK, 20 July 2016.

Ofwat were to adopt the proposal not to include the most complex sites during the transition period); and

- the extent to which there is a conflict between the new rules and WIA91 (in particular Rule 26, which moves Network Reinforcement charges into the new infrastructure charges).

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

The rules provide a basis for achieving the broad principles of the consultation. We note that the following clarifications and refinements to the rules would be advantageous.

Rule 3: This rule should include an additional transition arrangement which allows companies to set bespoke charges for complex projects (at least for the transition period), providing that the total revenue received from fixed connections charges does not fall below 80% of the total received in the year and/or the projects include one or more of the following characteristics:

- over 0.5km in length;
- over 250mm diameter pipework;
- waste rising mains;
- rail & tube line crossings;
- river & canal crossings;
- syphons;
- designated land;
- archaeology; or
- contaminated land.

Rule 5 (l) (ii): This rule contains a partial list of the types of infrastructure which companies must include in the Network Reinforcement charges. It would improve customer understanding if this also included monitoring equipment such as permanent telemetry solutions and peak flow monitors.

Rule 5 (r): The limitation of "*Site Specific Work*" to connections "*in the immediate vicinity of the development*" may confuse customers who are more familiar with the terms "communication pipe", or "lateral drain" to refer to the pipe which connects the site to the network.

An amendment that sets out the length of laterals or communication pipes that are to be charged for would be helpful.

The term "*Site Specific Work*" should include all work involved in joining the development to the point of connection, such as the cost of compensating landowners, and disruption to other customers which arises from the making of connections.

Rule 7: We are concerned that the implementation timetable may be too tight for companies to comply with Rule 7 as currently drafted.

Rule 19: This rule uses the term "present rules". It was not clear to us whether this wording works when the new rules are in force.

Rule 21: We are concerned that there may be a conflict between this rule (to set charges which promote effective competition) and the concept of charges fixed in advance. For any given connection, a price fixed in advance will either be higher or lower than the actual costs. This raises two potential competition concerns. First, where the fixed price is below the true cost of delivering the work for that specific site, whilst the developer will benefit, SLOs may find it hard to compete for the connections work. Second, where the fixed price is above the actual costs, SLOs will be aware of this, and have an incentive to increase the price of their bids, to the disadvantage of the developers.

Rule 25: The rule should include an additional transition arrangement which allows companies relief from setting fixed charges on bespoke or complex projects, as per our suggestion above for Rule 3.

Rule 26: It was not clear to us whether the current wording of Rule 26 is consistent with WIA91, Section 43(4) and Section 100(4). Specifically, Rule 26 states "…*such charges may* *<u>not include</u>* *any amount for network reinforcement costs…*", whereas WIA91 states these charges "…*<u>shall include</u>* *… the costs reasonably incurred …"* [our emphasis].

The rule refers "physical infrastructure" which may confuse customers as it will not be clear that Requisition Charges are intended to include costs such as street works costs, lane rental, compensation for disruption to other customers, etc.

Rule 27: See comments under Rule 5 (r).

Rule 36: See comments under Rule 5 (r).

Rule 41: "Diversion Charges" is presented as a defined term, although it is not a defined in Rule 5.

Rule 43: As we understand it, the term "deposit" is not strictly correct, as it can have a specific legal meaning which would not be appropriate here. We believe that the rules should refer to "cash collateral" rather than "deposit".

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

We agree that the charges scheme rules provide a basis for achieving the broad principles of the consultation. We note, however, that Rule 28 may not operate as intended if housing growth is lower than forecast. In these circumstances, companies will be required to recover the cost of early investment from a smaller number of connections than envisaged. This will increase the charges to developers, thereby making new developments less economic at a time when housing growth is declining.

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

We agree with the proposed licence modification wording.