Yorkshire Water
Western House
Halifax Road
Bradford
West Yorkshire
BD6 2SZ

T: 01274 692208
M: 07790 617192

Charging - Ofwat
21 Bloomsbury Street
London
WC1B 3HF

26 August 2016

Dear Sir or Madam,

Consultation - New connections charging

Thank you for the opportunity to comment on your draft new connection charging rules. We are broadly supportive of your approach towards the comprehensive review of new connections charging. To contribute to the consultation process and support your objective to get developer charging right, we would like to make the following high level comments:

1. Rule scope and governance: The scale and scope of the proposed connection charging rules is gradually increasing. There are now over 50 individual new connection related charging rules which range from high level principles to points of detailed instruction.

   This is in contrast to the 25 charging rules for the remainder of our Charges Scheme and 26 (often identical) rules for all of our wholesale charges. We do appreciate that there is a fine balance between controlling the quantity of rules and overhauling the charging regime but would suggest that this balance undergoes regular review throughout the process to ensure that the more proportionate regulatory oversight of charging intended in the Water Act 2014 is achieved. This would ensure that any unintended consequences in relation to the complexity and intrusiveness of the charging scheme are avoided

2. Cost reflectivity and charge rebalancing: We agree that the current balance of charges between developers and existing bill payers should be broadly maintained in the short term. However, if major imbalances do currently exist, we think that these should be unwound over a suitable period to ensure that the new charging system can, in the future, be clearly cost-reflective.

   We are aware that Defra is consulting on the strategic charge/cost balancing point (see Q1 of their draft guidance to Ofwat) and we do not yet know the Government's final policy position on this key boundary condition.

3. Contestable charges: We continue to question the requirement to publish upfront fixed charges in all contestable markets, including where water and sewerage companies are very minor players in those markets such as onsite sewer laying.

Our competitors in these contestable markets will not be obliged to publish upfront fixed charges (appendix 1, rule 25) and their associated derivations/methodologies (appendix 1, rule 9) which place incumbents at an immediate disadvantage. We note that the draft rules provide more charging flexibility to incumbents for non-contestable infrastructure charges (appendix 2, rule 31) than it does for contestable onsite requisition charges (appendix 1, rule 25). This appears to run counter to the operation of markets and does not provide for a level playing field.

Costs are site specific and upfront charges can therefore only be indicative. Given the site specific nature of onsite costs any upfront charges will have to be averaged. This may create an unintended consequence whereby incumbents are suspected of over/under charging individual developer sites. This could potentially lead to complaints, based on average charges, not actual charges, being made under competition law. To avoid this situation we would suggest that if upfront charges are to be obligatory, they should be provided on an indicative basis with supplementary "alternative (true-up) methods" always applied for calculating actual site specific charges in these contestable markets.

We hope that you find these observations useful; they are intended to stimulate a regulatory debate on three broad aspects of the charging rule development. Our detailed response to the questions posed is attached in annex. If you would like any more information or details regarding our response please contact David Musca, Tariff Specialist using the following e-mail address, David.musco@yorkshirewater.co.uk.

Kind Regards,

Wendy Kimpton
Head of Regulation

YorkshireWater

Response to Eight 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?

Yes we agree with the key features and (general) approach of your March proposals. We provide positive comment on the individual proposed updates and clarifications under Question 2. We do have some reservations on the current definition of income offset which are detailed in Question 6 and regarding network reinforcement in Question 7.

Greater cost reflectivity and associated cost transparency should continue to be the central tenet of the Regulators charging rule proposals.

We also support the proposed evolutionary approach, noting that "*rules are likely to evolve in future years reflecting on learning*" and welcome the Regulators intention to keep the consultation about future of developers charges rules whole by embracing both infrastructure charges and other developer charges in the same consultation document.

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

We respond to the topics raised in section 4 as follows (we have numbered appendix 1 rules as 1.X and appendix 2 rules as 2.Y):

No Principles Hierarchy: We agree that there should be no hierarchy in charging principles. We do recognise tensions for the next few years between delivering greater cost reflectivity and site specific bill stability.

Tailoring Infrastructure Charges: We support the increased flexibility provided on infrastructure charges as outlined in rule 2.31. This will ensure that companies are better able to reflect their local cost circumstances.

Charges for STWs: We support the proposal to exclude associated costs for improvements in STWs from requisitioning. We would like to see clarification regarding the economic rationale for excluding these developer driven costs from infrastructure charge coverage.

Infrastructure Charge Credits: We support the clarification on not preventing companies from offering credits for previous usage. Although we note this is required by section 146 of the WIA91.

Promoting Competition: We support the new rule, 1.21, that states that charges should promote effective competition for Contestable Work.

Customer Engagement: We support company ownership of the consultation process and that it should be proportionate.

Customer Focus: We support customer focused charging, especially where it enables greater cost reflectivity (without creating increased and costly administrative burdens).

Infrastructure Charge Stability: We support the 5 year rolling average concept.

Rule Interaction and Rule Alignment: There is a clear tension between the need to forewarn customers of material charge changes and the requirement that charges need to be published by January/February 2017. This means that there are only four months from the closure date of this draft charging rule consultation, noting that final charging rules are unlikely to be available until Autumn 2016.

Phasing significant changes: When developer charges have been dominated by a single national fixed property charge there is also a clear tension between providing for more cost reflective, and Competition Act (CA98) compliant developer charges, and providing a stable/predictable charging environment for individual developers from 2017.

Indicative Charges: Where charges may not be stable it is proposed that companies publish indicative charges for future years.

The consultation states that "*companies should consider publishing indicative infrastructure charges for different development scenarios within their charging arrangements, where such information could be helpful*".

Given the extremely tight timescales for 2017 we think that this proposal is something for future infrastructure charges. We also think other information sets such as published housing projections by local authority sitting alongside colour coded maps of network capacity constraints, could be better used to signal to the market where/when infrastructure charges are susceptible to future material change. And we will consider these enhanced information possibilities for 2018.

We will not be providing indicative future charges in contestable markets.

Environmental Protection: We support "*a general requirement on companies for them to consider the role of charging structures that send environmentally beneficial price signals when developing their charges*".

However, as discussed below, it is proposed that infrastructure charges should be constrained to only recover network reinforcement related capital costs. The potential of then using these same charges to signal the long run cost impacts of new development further upstream, when these costs have been explicitly excluded from the charge, could be questioned.

In terms of price signalling an alternative method could be to focus environmental signals on size development thresholds below which reinforcement is rarely required and locational signals where the local networks are running at/close to capacity, especially during their peak hour periods.

RPI: We support maintaining RPI as the measure of inflation applied to infrastructure charges during the transition period.

Charging Rule Interactions: We understand that wholesale charges are covered by different charging rules.

To set reasonably accurate indicative wholesale charges by 01 October 2016 companies will need to gauge the developer revenues that will be received from associated connection charges. To achieve this we would have to obtain a clear view of connection charges and expected market activity at the same, in early September.
We therefore propose that we employ an interim solution to this immediate wholesale-developer charging rule interaction problem is to initially assume that expected revenues from developers will remain as per the Final Determination (with an adjustment for excluded connection charges) and to then set indicative wholesale charges on this assumed developer revenue basis.

This would then also mirror Defra's draft connection charging guidance that "*the current balance between contributions to costs by developers and bill payers should be broadly be maintained".*

Regulatory Tools: We note the intension to use a wide of regulatory tools including annual assurance reporting, the company monitoring framework, annual performance reporting and risk based reviews. These are in addition to formal enforcement action for rule breaches. We would like to suggest that a consideration of the scale of the revenues involved against the proposal is carried out to ensure it is proportionate and efficient.

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?

Income offsetting and asset payments may "*recognise revenue likely to be received by the relevant undertaker in future years for the provision of supplies of water [and sewerage services] to premises connected to the new Water Main [and Sewer]*".

This revenue relates directly to future wholesale services. Hence this potential revenue recognition may be better located on associated wholesale related developer charges; the infrastructure charge. If economically justified the revenue reward would then be potentially available to all parties who provide these same wholesale benefits via the different asset delivery routes.

Not offsetting the requisition charge *for the provision of a Sewer or Water Main* has clear merits with regard to providing a transparent level playing field in these more contestable on-site markets. It would also better enable the new proposed pro-competition rule 1.21.

The consultation states that the potential interaction with the current (and future) price control is one possible reservation about this suggestion.

In discussing the demerits of switching the charge location of the income offset the consultation states that "*eliminating the need for asset payments, which are treated as a cost; improves companies financial position by reducing their overall costs*".

We are uncertain about the first part of this claimed disadvantage. Currently the revenue benefit is either paid via a reduced requisition charge to developers or as an asset payment to SLOs. Under the outline proposal the revenue benefit, if it is justifiable, will be paid to all parties via a reduced infrastructure charge. So under the self-lay option the revenue reward for the development would be made via the reduced infrastructure charge, as opposed to an asset payment.

The main risk to the generality of customers is if incumbents loose substantial on-site water main laying business to new entrants. The incumbent's water costs will then reduce as a result of this market shift. In this situation wholesale water revenues will be maintained via the single till mechanism.

Our understanding is that this type of transitionary revenue protection is why the single till was introduced by the Regulator; "*to provide greater stability to total bill revenues collected over the period of the new price controls*", noting "*the balance between connection and infrastructure charges, and other wholesale charges could change*" as a result of WA2014 implementation.

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

In our response to the emerging thinking consultation we said that "*An Autumn date for final charging rule publication could leave insufficient time to prepare for a significant change in the developer charging regime*….*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"*.

The timeframe for introducing such a major shift in the connection charging regime is still extremely challenging. We will continue to endeavour to introduce the new connection charging regime by April 1 2017, as currently proposed.
However, we recognise that some changes, additions and clarification have been included in this consultation when compared to your emerging thinking document:

- *Changes* include rule 1.11 on the need to explain how each charge has been calculated or derived, rule 2.31 on providing greater flexibility on the nature of infrastructure charges, and rule 1.5 on the definition of the Income Offset.
- *Additions* include rule 1.12 and rule 1.13 on the need to provide worked examples and service descriptors, with charge phasing being encouraged to provide associated bill stability.
- *Administrative clarifications* include rule 1.10 requiring connection charging arrangements to be published 2 months before coming into effect, noting that new appointees have a shorter 5 week period to publish.

Generally whilst we welcome these proposals this shift in connection charging policy may impact on our internal project timelines to deliver all connection related charges for April 1 2017.

Ofwat's consultations on charging related matters have traditionally been published in the Spring .This provided companies adequate time to both respond and then prepare for the coming charging year. The 1st February publication of charges schemes has constrained the time companies have available to prepare for the April 1 start date. To allow appropriate resource and activity planning we would welcome a return to the Spring timed charging related consultations cycle.

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 have no comment.

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

We have some reservations about the proposed relatively broad definition of the "Income Offset", noting this is based on sections of the WIA91 that are about to be repealed or substituted.

The income offset is defined by Ofwat in rule 5 as:

"*a sum of money offset against the charges that would otherwise be applied for the provision of a sewer or water main in recognition of revenue likely to be received by the relevant undertaker in future years for the provision of:*

i. supplies of water to premises connected to the new Water Main; or
ii. *sewerage services to premises connection to the sewe*r.

and "Income Offsetting" shall be construed accordingly."

The sections of the WIA91 due to be repealed infers that only revenues apportioned to those mains provided can be used to develop the income offset. The relevant/estimated revenue in respect of a water main or drainage charges payable is:

- "*So much of the aggregate of any charges [expected to be] payable to the undertaker which…are reasonably attributable to the provision of a supply of water (whether or not for domestic purposes) to those premises by means of that main* (43A/43)".
- "*So much of the aggregate of any charges [expected to be] payable to the sewerage undertaker that…are reasonably attributable to the use of that sewer*" (100/100A).
- "*Estimated revenue (if any) in respect of the adopted main for that year* (51C)".

The linkage between revenues and the local on-site network assets provided via requisitioning/adoption is also made explicit in the introductory paragraphs to the above WIA91 sections.

We believe the rule 5 definition, which potentially embraces all service revenues, is not in the spirit of the existing statutes relating to relevant revenues. In our opinion if the spirit is to be maintained then the income offset should be restricted to future revenues that are "reasonably attributable" to those requisitioned/adopted mains and sewers.

We also continue to question the fundamental economic rationale of income offsetting and welcome the option of not being obliged to make this financial transfer if a supporting methodology cannot be economically justified.

We have expressed our reservations on the proposed rule to publish and explain upfront fixed charges in all contestable markets in our cover letter.

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

We have some reservations about the proposed definition of "Network Reinforcement" as it pertains to rule 2.28. This states that infrastructure charges will only cover the costs associated with this particular network reinforcement activity.

In rule 5 Network Reinforcement is defined to include "*work to provide or modify such other: i) water mains and such tanks, service reservoirs and pumping stations, or ii) sewers and such pumping stations*" that are a direct consequence of requisitioning, adoption or the right to connect to a sewer.

This narrow definition of infrastructure charge coverage is drawn from the statutes that relate to requisitioning (see sections 43 (4a) and 100 (4a)) and not those that explicitly relate to infrastructure charges (section 146).

Section 146 states that undertakers can demand a charge for the connection of new domestic-like premises for water and sewerage services. It does not define what costs this charge should cover and so this is a new regulatory cost definition, made under new rule making powers.

We think that two policy questions should to be considered;

1. What is the economic rationale for excluding treatment and other upstream assets from the reinforcement cost equation?
2. What is the economic rationale for focusing on "works" i.e. capital investment in *networks?*

On the first question we note that pre 1995 *"the infrastructure charge was intended to cover the costs associated with works to remote infrastructure (treatment works, resources, trunk mains and the like) necessary to cater for new connections.* Post 1995 Ofwat decided that *"infrastructure charges should relate to local distribution costs only, rather than increases in resources and treatment capacity".*

We accept that re-embracing the total cost impact of new connections along the full service value chain as part of the infrastructure charge for connections may cause incidence effects for developers. Given Defra guidance on the need to maintain the current cost balance this may be a legitimate regulatory rationale for limiting developer associated costs for infrastructure reinforcement to just downstream networks.

We would like to suggest that the restriction to infrastructure charges coverage to exclude and thereby socialise all future non-network related asset costs would benefit from regulatory explanation. The generality of customers may want to know why these new development driven capacity costs are being recovered through their standard charges. The proposed non network cost exclusion policy will reduce the possibility for any associated income offsetting on these same excluded non network upstream assets.

On the second question the regulatory regime has recently shifted to a totex approach. By focusing solely on “works” for reinforcing network assets there may be an element of capex bias being rebuilt into the new developer charging regime.

In many cases network reinforcement can actually be avoided by increasing company operating costs, for example, by pumping more water through the existing network and accepting higher head loss and higher leakage. By not clearly including these network operating costs in the definition of network reinforcement it is not evident as to whether any consequential increase in operating costs may be recovered from developers via the targeted network infrastructure charge. This possible network opex exclusion will further reduce the possibility for any associated income offsetting on downstream network assets.

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

We have no comment.