

Sent by email only

By email: charging@ofwat.gsi.gov.uk

4 August 2017

Dear Ofwat

Response to: New Connections Charges for the future - England

The current approach to income offsets and asset payments significantly distorts the competitive market for NAVs in favour of incumbent water companies. Such discrimination forecloses the market to competition in many cases. Consequently, we welcome Ofwat's consultation on proposed changes to the application of income offsets and asset payments. Without these proposed changes we believe the new connection charging rules would largely be ineffective in facilitating competition in the near term. Our detailed responses to the questions are provided in the Annex to this letter. In summary:

1. We agree that income offsets and assets payments should be applied to the infrastructure charge component of the connection charge.
2. We do not support the continued distortion and discrimination in the application of connection charges to NAVs (Option 1 as set out in Ofwat's consultation). Further, we do not support any further delay in the implementation of fair connection charging rules (Option 2b in Ofwat's consultation). Implementation of new connection charging rules has been delayed already from 2017 to 2018.
3. Option 2a is our preferred option as we believe it offers transparency. However, we understand that Ofwat's Option 3 is the equivalent in effect to Option 2a in that an income offset offered in a bulk supply agreement will be calculated on the same basis as an income offset applied to the connection charge; i.e. under the bulk supply agreement the NAV would receive a lump sum payment on an equivalent basis to the income offset that would be applied under Option 2a.
4. On that basis we are happy to support Option 3. For the avoidance of doubt, we would not support a solution that allowed the income offset to be reflected in the bulk supply tariff offered without full transparency. We can see, in those circumstances, that there is a risk that the income offset may not be fully applied as it should be. In line with Ofwat's stated guidance, water companies need to be transparent and timely in their calculation of their income offset for a NAV. In our experience, there is little transparency and negotiations between a NAV and a water company can be stretched

out over many months. This delay alone frustrates competition, as developers cannot wait that long for a competitive offer from a NAV.

We believe that implementing the proposed change to the connection charging rules will be a significant step forward in addressing the competition issues faced by NAVs. One of the main barriers to competition is the treatment of income offset. The other main barrier is that of margin squeeze through non-cost-reflective bulk supply tariffs and this also needs to be addressed to make competition work, otherwise the new connection charging rules, and this work to address income offset, will have limited impact.

Water companies still have much work to do on the development of their boundary tariffs to NAVs that comply with the requirements of competition law. Some companies are now starting to address this issue, though some propose a NAV margin that is well below the margins that their own notional downstream business would require to operate the network and make a normal return. We believe many water companies are waiting for the issue of the Ofwat report following the investigation into the NAV market before they will take their responsibilities seriously. We also note that, apart from Anglian Water and Severn Trent, no water company has consulted yet on their proposed new connection charges. Again, we believe they are waiting on the issue of the Ofwat report.

In the circumstance, we would welcome the early issue of the Ofwat report on NAVs and hope that this will provide the momentum to finally deliver a truly competitive water market.

If you wish to discuss any of our responses to your consultation please contact me.

Yours sincerely

Michael Harding
Regulation Director

Annex 1 – Responses to Ofwat Questions

Q1: Do you agree that our Option 3 on the treatment of the income offset/asset payments, has merit? If not, please explain your reasoning and provide relevant evidence. If so, how and when should this change be brought about?

Our preference is for Option 2a over Option 3. We do not support Option 1, retaining status quo; nor do we support option 2b, delaying implementation until 2020. Implementation of new connection charging rules has been delayed already from 2017 to 2018. We do not support further delay to 2020 in the implementation of fair connection charge rules that facilitate competition.

As identified by Ofwat Option 2a offers a remedy that is transparent and as a consequence, more likely to result in fairness and promote effective competition. However, we note Ofwat's concern that option 2a could result in "*higher, but temporary, end customer bill[s]*". Ofwat indicate that this is because of the different accountancy treatment of infrastructure charges and income offsets within the price control rather than a consequence of a net increase in "*tariff support*"; i.e. it is not a rebalancing of infrastructure charges. We are surprised that this issue cannot be addressed within the price control framework particularly where, as we understand it, water companies are keen to address competition concerns.

In the long term, we understand that the impact on customers would be at least neutral; however, we note Ofwat's comment that it expects the regulatory burden to be lower under option 2a compared to the status quo and that this would have a downward pressure on costs.

Option 3

Notwithstanding the above, we note that Option 3 is Ofwat's preferred solution. We recognise the intent of Option 3 (at least in theory and effect) is to have some broad equivalence to option 2a for the years 2018/19 and 2019/20 and thereby better facilitate competition. We understand the effect of Option 3 is that:

- an equivalent income offset "payment" will be provided to the NAV as part of the bulk supply agreement;
- such payment will be calculated on the same basis as the income offset under option 2a;
- the timescale for applying such payment will be consistent with that for the application of income offset payments. We would not expect such payment to NAVs to be unduly delayed or withheld or subject to materially different terms to SLPs and developers; e.g. because of a failure by the water company to progress completion of the bulk supply agreement.

We would expect the mechanisms for the application of income offsets under Option 3 to be clearly set out in the connection charging methodology, in line with Ofwat's clear requirement for transparency. In our experience water companies provide very little transparency on charges to NAVs and also draw out subsequent negotiations for a fair charge for many months, often well over a year. Without a clear requirement

for transparency and a level playing field, water companies could in fact continue to frustrate competition until 2020 under this option 3.

Q2: Do you agree with our draft impact assessment? Can you provide quantitative figures in terms of the potential benefits or costs? Is there anything we have missed?

We are unable to comment on the cost information provided in Tables 4 and 5 of the consultation. As commented above, we believe the proposed change is a key part of opening the market to competition.

Boundary Tariffs to NAVs

However, in parallel with this, it is essential that water companies work quickly to address the margin squeeze issues that arise from the boundary tariffs they apply to NAVs and the methodologies that underpin such tariffs. In many cases the margins made available to NAVs are inconsistent with, and well below, the margins that the water company's own notional downstream business would require in order to operate the network and make a normal return.

Our concerns on boundary tariffs offered to NAVs are not new to incumbents. They have had ample time to consider remedies that are compliant with competition law. We believe such tariffs should be available from all water incumbents from April 2018 at the latest. We recognise that one or two companies have started to develop such tariffs; however, many are yet to show any meaningful intent. We believe this is an area where serious intent and urgency is required. We believe many water companies are waiting for the issue of the Ofwat report following the investigation into the NAV market before they will take their responsibilities seriously. We also note that, apart from Anglian Water and Severn Trent, no water company has consulted on their proposed new connection charges. Again, we believe they are waiting on the issue of the Ofwat report.

In the circumstance, we would welcome the early issue of the Ofwat report on NAVs and hope that this will provide the momentum to finally deliver a truly competitive water market.

Assessment Approaches

With regards to the two options considered by Ofwat on the publication of upfront charges, we agree with Ofwat that Approach 1 (to clarify the existing rules) is preferable when compared to Approach 2 (to restrict publication requirement to at least a % of revenues from certain services). Approach 2 lacks transparency and is unhelpful in providing clarity and certainty on the basis of charges to those parties whose connection requests fall outside the upfront charge. Additionally we agree that Approach 2 provides more of an opportunity for gaming and undue cross subsidy. We agree that it would be a difficult if not impossible task to accurately set a percentage value to revenues of certain services. We believe the principle based approach under Approach 2 needs to be applied consistently across all incumbents.

Q3: Do you have any comments on the drafting of the possible future changes to our rules (set out in Appendices A3 and A4)?

We have no specific comments on the proposed drafting on the Charges Scheme rules and charging rules for new connections from April 2020.

Q4: Do you have any comments on our proposed licence modification to Condition C (Infrastructure Charges) for English water companies other than NAVs (including the proposed wording set out in Appendix A7)?

We have no specific comments on the proposed drafting for Condition C.