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Strategy & Regulation

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Dear Sir/Madam,

Consultation on new connection charges for the future - England

Thank you for the opportunity to respond to the consultation on new connection charges for the future in England. Our response is set out below. For ease of reference, we have repeated the consultation questions.

- 1. 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?**

We believe that the treatment of the income offset/asset payments in option 3 has merit because it addresses competition concerns as of April 2018 and increases transparency as of 2020.

Companies will need to deploy a number of IT, process and policy updates to implement option 3. It will be important that companies are given sufficient time to make these changes and discuss them with their customers before they take effect. To help inform the calculation of 2018/19 indicative wholesale tariffs published in October 2017, the final rules would need to be confirmed in early September 2017.

- 2. 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 concerned that the draft impact assessment as it stands may not take proper account of:

- how the income offset is to be provided to NAVs, and, in particular, the different RCV impacts of the different options;
- the tax implications; or
- transition arrangements.

We provide more detail of these points below.

How the income offset is provided to NAVs

The income offset could be provided to NAVs in one of two ways, either as a lump sum, or as a discount on the bulk supply price. There are material differences in the impact of these two options that would need to be managed, particularly with respect to the RCV.

When new premises are connected to an undertaker's network, all else being equal, the undertaker would make greater profits in the future due to the return earned on the RCV arising from those premises being connected. When a developer comes to the incumbent for a requisition, the undertaker makes contributions to the developer's cost based on the additional future return that would be received from the new premises (i.e. because of the additional returns that will be earned on the incremental RCV). The future profit stream from a NAV is materially lower than from a requisition, as the RCV will accrue to the NAV, rather than to the incumbent. There is, therefore, no future incremental RCV to fund a contribution to a NAV (and, therefore, undertakers have not typically made a contribution to NAV costs). If undertakers make the same lump sum payment to NAVs as they would to developers, it will be important that the RCV is increased by this amount, i.e. the contribution to the NAV needs to be added to the undertaker's RCV to make the situations equivalent.

Alternatively, the value of the income offset could be provided to NAVs as a discount to the wholesale tariff. This option does not require the amount to be added to the RCV, on the assumption that price controls continue to target the total revenue required by undertakers (and, therefore, to the extent that prices are reduced for NAVs, there is an equivalent increase to prices for other customers).

Tax implications

We note that the tax impact arising from requisitions is different to infrastructure charges because the income is recognised over different periods. To the extent that the net tax impact (including VAT) of applying the income offset to infrastructure charges, rather than requisitions is material, this would need to be taken into account in the impact assessment.

We also note that, if the income offset is provided as a lump sum, it might be treated as a fixed asset or a prepayment to be released over a period of time. If the treatment is to be as a fixed asset, it is not clear on what basis tax relief would be available as it is not clear what the underlying asset would be. This would need to be discussed with HMRC. As all costs paid under the current arrangement do receive tax relief, the proposal could mean less tax relief being available than at present, with customers potentially paying more tax than the current arrangement.

Transition arrangements

We feel there is merit in exploring the options for transition arrangements. In particular, without a transition arrangement, there is a risk that development projects that span the transition period could end up contributing twice for the same infrastructure. One option for avoiding this would be to waive infrastructure charges during the transition. Some clarification on the circumstances under which we have the ability to wave infrastructure charges would be useful.

3. 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 grouped our comments as follows:

- the broad balance of charges;
- the interpretation of rule 30; and
- other comments.

The broad balance of charges

These new rules focus on maintaining the broad balance of charges between our customers and developers. Historically, this balance has been somewhat dynamic, depending on the state of the housing market at any given time. It would be helpful, therefore, if a definition of the broad balance of charges was included as part of rule 5 of the Charges Scheme rules.

The inclusion of such a definition would help make it clear whether the rules were intended to:

- create a system that behaves in the same dynamic way as the old charges would have;
- create a charging regime which maintains the current business 'performance'; or
- design charges which maintain the FD14 level of 'performance'.

The interpretation of rule 30

Rule 30 of the new Charges Scheme Rules could be interpreted in a number of ways, and it is unclear how it would work in practice. It would be useful if there was a worked example, including the basis on which 2018-19 and subsequent years infrastructure charges should be set. In particular:

- Should the 2018-19 charge be based on actual network reinforcement costs (in this case the latest 5 year period of actual expenditure that could be built into 2018-19 charges would be 2012-13 to 2016-17), or should forecast expenditure for the five year period 2018-19 to 2022-23 be used?
- Should the charges be smoothed within the five year period (to aid stability and predictably)?
- If the five year forward looking approach is adopted, would an adjustment be required in subsequent years to true-up any difference between the forecasts used as the basis to set the infrastructure charges and the actual expenditure when known?

Other comments

- We think that the draft change to rule 47 of the Charging Rules should also apply to new connections, and not just to requisitions. (The cost of doing the work is equally affected by the environment whether it is a service connection or requisition.)
- We think that costs incurred as a consequence of a s101A scheme should be included in the definition of network reinforcement costs in rule 5 of the Charges Scheme Rules.
- We think that the definition of network reinforcement in rule 5 of the Charges Scheme Rules should be amended to include cross-border flows, so if a

development occurs in another area and increases the flow, the incumbent would pass on the charges, as is the case for NAVs.

- If option 3 is pursued, we think that rule 30 in the Charges Scheme Rules should be amended to say that the five year rule for setting infrastructure charges is before application of the income offset.
- We think that there may need to be some consequential amendments to the self-lay code of practice to reflect these changes, and to ensure that the definitions in the rules and the self-lay code of practice are consistent (for example the definitions of on-site vs off-site work).

4. 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)?

The licence modification to Condition C seems fair.

Please don't hesitate to contact me if you need any additional information.

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'Colm Gibson', is positioned above the printed name and title.

Colm Gibson
Head of Economic Regulation