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24 January 2019

Charging
Ofwat
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Birmingham
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Sent by email only to: [redacted]

Dear Sir/Madam,

Consultation on new connection charges for Welsh companies

Thank you for the opportunity to respond to the consultation on new connection charges for Welsh water companies.

We recognise the need for reform of new connection charging rules and support the need to promote clearer and more transparent charges for our developer customers. The implementation of a new framework of charging which would be created when the Welsh Government bring into force the necessary provisions in the Water Act 2014 creates a unique opportunity to address the current issues with the charging provisions in the Water Industry Act 1991 and our licence.

Whilst supportive of the need for change we remain concerned about the timing and forward timetable of the proposed change process. In addition we are concerned that Ofwat's preferred option may not in substance align with Welsh Government charging guidance.

When brought into force, the Wales Act 2017 will bring about further changes for developer customers. If these changes are implemented to the proposed timetable, customers of Welsh Water and other water companies operating on both sides of the England/Wales border, would face three different sets of rules and charging arrangements in quick succession. We do not consider that multiple changes in charging rules would be in the interest of our customers, the company or support economic development in general, especially at a time of unprecedented political and economic uncertainty. Even under option 2 there would be some differences between the English and Welsh rules and further consultation with customers would be needed upon implementation of the Wales Act. The administration and consultation processes needed to make two sets of changes during the 2020-25 period would also magnify the costs and complexity of transition. This in turn could increase the volatility of prices for customers. There could also be unintended consequences for the 'broad balance of charges' due to PR19 revenue correction mechanisms. All of which would

contribute to a reduction in transparency and increased complexity for customers, directly in contradiction with the stated goals.

We are also very supportive of the Welsh Government and Ofwat requirement to consult with customers on new charges. Indeed, we have already engaged with some customers on a limited basis to ensure that our response to this consultation reflects their views and to continue dialogue about developer customer priorities. Given the need for further Ofwat consultation, publication of final rules, formulation of charges by companies, board assurance, and timely publication of the charges themselves for application from 1 April 2020, we are concerned that time for meaningful, timely, effective and proportionate consultation with customers would be significantly constrained.

For these reasons, our preference would be for the implementation of a new basis of charging to be delayed until the Wales Act 2017 is brought into force, to minimise the number of changes that need to be communicated to customers. Alternatively, as a minimum, a 12 month period should be allowed between the new charging rules being published and the date on which they would come into effect. This would provide sufficient opportunity to engage meaningfully with all customer segments including self-lay providers, NAVs, housing associations and housebuilders, and allow scope for refinement to our plans based on their views.

Bringing the timing of these changes into line with the timing of the Wales Act 2017 would also provide further.opportunity to learn from the implementation of the changes to charging rules in England. Ofwat's preferred option for a set of principles-based rules for new connection services in Wales is broadly the same as the changes introduced in 2018 for companies operating wholly or mainly in England. Our analysis of the implementation of these new rules in England, suggests that there has been a wide variety of interpretations and applications across companies and that this has not served to address customer concerns around transparency and the need to address the perceived arbitrary nature of charges. It is also clear that many customers operating in England do not understand the way the new charging arrangements have been brought about and how companies have derived their new charges, which has increased scepticism and propensity for disputes to arise.

Some of these customer concerns were raised by customers at the WaterUK Developer Day held on the 15th November 2018 in Birmingham at which both Ofwat and DEFRA were represented.

Whilst Ofwat may have a preference for the rules in Wales to mirror, where possible, the English rules, it is important to note that many aspects for undertaking development in Wales are no longer aligned with England. In particular, there are already significant differences between the planning systems in the two jurisdictions and therefore a set of rules which takes into account the views of customers and supports Welsh policy and legislation should take precedence over aligning with the English rules. Clearly, the current consultation would be undermined if the preference for aligned rules were to take precedence over consideration of the appropriateness of the approach.

Our detailed responses to the specific questions raised in the consultation are set out in the appendix. We look forward to engaging with Ofwat in due course on the evolution of new connection charges in light of the outcome of this consultation.

Yours faithfully,

Director of Strategy and Regulation

Appendix: Dŵr Cymru Welsh Water's response to the consultation questions is set out below.

1) Do you agree with our preferred option, option 2, for Welsh new connections charging rules?

No. We are concerned that option 2 may not align with the Welsh Government's new connections charging guidance.

Welsh Government guidance notes developers' preference for a 'simple, averaged cost charging structure that applies across an undertaker's area' and states importantly that the charging rules should not restrict innovative approaches undertakers (in line with customer/stakeholder support) may put forward, provided that the alternative approaches comply with competition law requirements. Paragraph 26 of the draft charging rules states that the requisition charge must relate to "the cost of providing **the** requisitioned Water Main and /or public sewer". Paragraph 27 states that the requisition charge must relate only to "Site Specific Work". Complying with these paragraphs appears to prevent a simple average cost charging structure under option 2. As currently drafted option 2 limits our ability to consider a range of options for charging and appears to lead companies towards a single option, being a "pick and mix" menu of components of charges based on actual costs, to be compliant with the rules.

Further, we do not accept that option 2 resolves the issues of unclear incentives for self-lay providers. Indeed the draft rules create a material conflict between the requirement to make an asset payment which is equal to the income offset (paragraph 30b) and at the same time to increase the income offset if infrastructure charges increase (paragraph 30c). A potential consequence of this is that the profitability of any individual self-lay scheme will be linked to the amount of network reinforcement the company has had to undertake in any given period.

Option 3 is our preferred option. Option 3 would allow the ability to transition to a fixed price per plot, which is our current understanding of customers' preferred pricing model. Whilst this is our current position for constructing new connection charges, we recognise the need to formally engage with all customers before undertaking the detailed design. This model is, we believe, consistent with both Welsh Government guidance and in line with Ofwat's stated objectives, and also builds on the feedback from the implementation in England of new charging rules and our ongoing engagement with customers. It would allow companies to manage the impact on customers of the implementation of the Wales Act when it comes into force and protect customers from unnecessary multiple changes in charging arrangements. Furthermore, option 3 would allow greater scope for companies to react and innovate to meet changing developer priorities.

In describing option 3, the consultation document states that Ofwat would not address specific issues raised by the Welsh Government, such as promoting SuDS. In order to align with Welsh Government guidance, Option 3 could include a principle that the charges should incentivise policy considerations such as sustainable surface water solutions, together with a principle requiring the balance of charges to be maintained between developers and other customers.

2) Do you have any views on whether Welsh companies' charging arrangements should apply differently to single-build and multiple-build applications?

We do not think that there should be different arrangements for single build and multiple build applications. Having a single set of rules which applies to all new connection applications would simplify charging arrangements and remove the current disadvantage faced by single build developers who do not benefit from an income offset.

3) Are transitional arrangements necessary and if so what should apply?

Again, the views of our customers are of paramount importance when it comes to transitional arrangements. We currently enjoy high levels of customer satisfaction and with the introduction of the D-Mex developer satisfaction measure, the consequences of not meeting customer expectations are significant. We have written separately to Ofwat on our concerns about the D-MeX measure.

A long transition would create confusion for customers and would be challenging for our colleagues to administer, both in turn increasing costs and inefficiency. It could also lead to issues with maintaining the balance of charges between developers and existing customers. We therefore believe that a short or instantaneous defined cut-over between the two sets of arrangements would likely be the most appropriate. We had a good experience of this type of cut-over when Welsh Government implemented the mandatory sewer adoption requirements under section 42 of the Flood and Water Management Act 2010. A long transition period would also delay the realisation of any benefits of reduction in workload afforded by the new arrangements.

4) Are there additional ways in which our charging rules could reasonably promote the use of SuDS?

We already work with our developer customers to explore opportunities to remove surface water which currently enters our wastewater network across our operational area. To support this objective, we offer a financial incentive to developers that remove existing surface water from our network as part of the development of a housing site.

Option 2, is an inflexible and prescriptive set of rules which appears to restrict our ability to innovate in this and other areas of charging. Under option 3 we would continue with our existing surface water removal incentive scheme and to innovate to identify opportunities to support sustainable outcomes and to reduce the demand new developments make on both clean and waste water services.

5) Does the preferred approach place an undue regulatory burden on Albion Eco? If so, what approach would maintain customer protections while avoiding an excessive regulatory burden?

We would expect a level playing field with no one company put at a disadvantage. Option 3 would provide a standard set of principles without being overly prescriptive and would therefore enable proportionate interpretation of the rules by the various companies, including Albion Eco.

6) Are there additional issues, not identified in this consultation, that relate specifically to Welsh companies, which we should take into account when developing new connection charging rules?

There are a number of differences in regulations and legislation in Wales which need to be considered when developing new connection charging rules. These include:

- building control regulations introduced in January 2016 which made fire sprinklers mandatory in all new properties in Wales;
- the mandatory adoption by water companies of new sewers;
- the implementation in Wales of schedule 3 of the Flood and Waste Water Management Act 2010 in January 2019 which introduced sustainable urban drainage approval bodies (SABS); and
- statutory consultee status of water and sewerage undertakers in the planning application process.

We are concerned that this consultation is predicated on the PR14 price control methodology rather than the PR19 approach that will be in place when the rules come into force. This is particularly relevant to Welsh companies as English companies were able to submit their PR19 business plans using the new rules whilst in our PR19 plan submission we have assumed, (as we do not currently have new charging rules) that the status quo will persist for the duration of AMP7.

The "price controls" paragraph that you have included on page 18 is certainly true for the methodology for setting and recovering wholesale revenue for PR14. However, the PR19 methodology is introducing a separate correction mechanism for developer services (see p12 of Appendix 7 of the 2019 price review methodology published Dec 2017) based on the expected average revenue of providing services. Moreover, the correction mechanism for developer services revenue has changed from an annual true-up in PR14 to a period end true-up for PR19. These two changes mean that any fundamental change to the way that the charges are set whilst the PR19 settlement is being determined will run the risk of being "baked in" to the price control and could have a significant impact on either customer charges or developer services income until 2025.

The Developer Services income included in the current PR19 Business Plan, which was submitted in September 2018, has been forecast on the basis of the current charging methodology. This has also informed the calculation of the average revenue to be used for the correction mechanism.

Ofwat's Initial assessment of our submission (IAP) will be published after the response to this consultation has been submitted. Therefore, whilst taking this opportunity to make you aware of a potential significant issue, we think that this is an area that we should work together to resolve before the full consultation on the charges rules is published in spring 2019, after you have reflected on the responses to this pre-consultation.

7) Do you have any comments on the drafting of our proposed new connections charging rules, proposed changes to the charges scheme rules or proposed licence modification?

As outlined in our response to question 6, we are concerned about the significant risk that a company could inadvertently breach the requirement to broadly maintain the balance of charges between developers and other customers due to the interaction of the way business plans have been complied and the new revenue correction mechanisms for the 2021-2025 period.
In addition, as currently drafted the proposed new connection charging rules stay silent on whether the income offset currently applied to requisition charges would be transferred to the new

infrastructure charge as is the proposal for England. Our preferred option 3 would allow for alignment in England with English rules after the implementation of the Wales Act.

8) Do you have comments on our draft impact assessment? Can you provide quantitative figures in terms of the potential benefits or costs?

We note that in the draft impact assessment that you have based customers' implementation costs on the figures for implementing charging rules in England. You also rely upon responses (from customers and others) to the consultations on charging rules for English companies. We have reservations about the validity of this approach. Respondents are unlikely to have considered Welsh circumstances or Welsh specific issues when responding to consultations on charging rules specifically for England.

We disagree with the statement made that the ongoing costs of option 3 "will be higher than option 2, and potentially also higher than the status quo, because the high level nature of the rules will mean that enforcement is more protracted and complex". Whilst we haven't undertaken extensive customer research on this issue, we frequently hear from customers that the implementation of the new rules in England (approximately the same as option 2), has created considerable inefficiency due to the variety of interpretations and the significant range of infrastructure charges. We believe that maintaining the possibility of a fixed price per plot by pursuing option 3 would have a reduced ongoing cost relative to both the status quo and option 2 because developers will benefit from cost certainty and improved transparency. Option 3 would also allow us to be responsive to changing customer requirements and quickly and responsively make changes to charges without needing to rely upon the regulator making changes to the charging framework first.

We also disagree that customer costs would be lower for option 2 due to 'reduced familiarisation costs'. Many of our developer customers are organised on a regional basis and would not therefore have experience of the new English arrangements and smaller Welsh developers are less likely to operate on the other side of the boarder. Where customers are familiar with the new arrangements the variety of interpretations, range of levels of income offset and infrastructure charge mean that the new arrangements are not sufficiently embedded or familiar to justify a reduced customer cost assumption.