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By email

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Dear Regulatory Directors

Compliance with competition law and charging rules obligations with respect to the self-lay market for new connections

Ofwat has received a number of complaints over the last 12 months in which it has been alleged that incumbent water companies, through their charges, contractual terms and/or actions, have made it difficult for self-lay providers (SLPs) to compete and operate efficiently in the developer services markets. This is understandably of great concern to us and disappointing given we have previously written to companies regarding competition law compliance in the self-lay market (2015) and in general (March 2017, when we published guidance on our application of competition law in the water sector).

There are a limited number of markets in the water sector in which competition is able to take place and we are determined to ensure that water companies, whether deliberately or through lack of awareness and understanding, do not impede effective competition in these. I am therefore writing to all incumbent water companies to remind them that, given their position of dominance in a number of markets in their appointment areas, each company has a special responsibility to ensure that its conduct in those markets does not prevent, restrict or distort competition.

We note that the charging rules for new connection services (the 'Charging Rules')[1] explicitly require water companies in England to set their charges (including any

[1] Charging Rules for New Connection Services (English Undertakers) issued by the Water Services Regulation Authority under sections 51CD, 105ZF and 114ZA of the Water Industry Act 1991, 20 December 2018: https://www.ofwat.gov.uk/publication/charging-rules-new-connection-services-english-undertakers/.

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income offsets) and asset payments in accordance with the principle that they should promote effective competition for contestable work. Water companies are also required to publish their charges in a clear and accessible manner and explain how each charge has been calculated or derived so that it is clear what services are covered by each charge.

This means that, amongst other things, water companies should generally ensure that their charges in upstream markets (where, as the regional undertaker, only they can provide the relevant service or access and therefore are in monopoly position) allow sufficient margin for equally efficient companies to compete against them in downstream, contestable markets and that the charges reflect the actual costs of providing those upstream services. Where equivalent services are provided, water companies should charge competitors the same amount as they do their own downstream businesses. Companies should also ensure that their contractual terms are fair and reasonable and that they are sufficiently clear that purchasers are able to understand what charges will apply to the services they are buying and the circumstances in which they will apply. This helps avoid customers of upstream services suffering unnecessary delays whilst they seek clarification, and the knock-on effects of this on their ability to compete and operate efficiently in the downstream market.

It is disappointing that we have received complaints about a number of water companies that cover issues such as the level, clarity and application of design fees; the clarity and comparability of how requisition and self-lay charges are calculated; and the way in which asset payments and income offsets are calculated. The extent to which changes to companies' charging schemes for new connections are properly consulted on has also been questioned.

The complaints allege that it is not clear as to what services are included in the design fees and other developer service charges or how the charges for these services are calculated or compare between requisitioned and self-lay provision. It has also been questioned as to whether the charges allow sufficient margin to enable SLPs to compete with water companies for the provision of services. Similarly, concern has been raised that some water companies are not applying a consistent methodology when calculating income offsets in their charges for requisitions as when they calculate asset payments for SLPs. This prevents a level playing field that would allow for effective competition to take place.

On the basis of our assessment of the complaints, it is not clear to us that water companies are fully and clearly complying with the requirements of the Charging Rules. In particular we consider that many companies have failed to transparently demonstrate to us and customers how their charging schemes satisfy paragraph 21 of our charging rules for new connections which requires that "Charges (including any Income Offsets), any Asset Payments and arrangements for when they are each

payable must be set in accordance with the principle that they should promote effective competition for Contestable Work". We have set out more detail of some of our concerns arising from the recent complaints in the annex to this letter to illustrate the types of matters companies should be considering further.

We recognise that our Charging Rules are relatively new and that, by the nature of them being largely principles-based, they are open to companies taking different approaches in their charging schemes. However, both the charging rules and companies' competition law obligations require companies to ensure they are fully considering the effects of their charges and charging scheme documents on effective competition. The assurance statements companies are required to submit to us are intended to confirm they consider that they are complying with the charging rules and their legal obligations. If water companies are unclear as to what is required by the Charging Rules, we are happy to discuss this further with them. We have also published guidance on our approach to the application of competition law in the water sector.

Given the breadth of issues and companies concerned, at this stage we have chosen to highlight our concerns publicly to all companies and to emphasise the need for all companies to focus their attention on these matters as a matter of urgency. We will continue to review companies' performance and assurance statements with respect to the charging rules. Having put all companies on notice of our concerns via this letter, we are now more likely to consider escalating our response through our formal enforcement powers where these issues are not addressed promptly, or if we identify any future breaches of the Charging Rules or of competition law.

It is imperative, therefore, that all water companies take action to ensure that their practices in these areas are consistent with their competition law and other regulatory obligations. Companies should be taking appropriate steps to ensure that charges are cost reflective and that their approach to setting any charge or income offset is transparent and does not result in a situation where an equally efficient competitor is unable to compete with it on a level playing field. If water companies are effectively consulting on their proposed new connection charging arrangements with customers and stakeholders, they should be able to identify and comment on any potential issues before the charging arrangements come into effect.

We would also like to note that, as set out in our November 2017 decision on new connections charging,[2] it is our intention that from April 2020 the nature of income offsets will be changed so that they are applied to infrastructure charges rather than to water main or sewer requisitions. Infrastructure charges are payable by the customer to the water company whenever a new water or wastewater connection is made, regardless of whether the work to make a connection was carried out by the water company or by a competitor such as a self-lay provider. As a result, this will remove the need for the water company to offer asset payments as the new income offset will not affect the charges that a company imposes on customers for contestable new connections work.

Yours sincerely

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[2] Ofwat, New connections charges rules from April 2020 – England: Decision Document, 2 November 2017: https://www.ofwat.gov.uk/publication/new-connections-charges-rules-april-2020-england-decision-document/.

Annex: Areas of concern

The examples below relate to the way in which asset payments and income offsets are calculated and the fees relating to design services as these were the areas covered by the complaints that we received. Water companies should, however, ensure that, where applicable, all their charges comply with the Charging Rules and with general competition law.

Inconsistent application of methodology to calculating Asset Payment and Income Offset

We have identified that some water companies are disadvantaging self-lay providers when calculating asset payments and income offsets. This is particularly the case where income offsets are set to be a percentage of requisition costs.

In some areas, water companies have identified that when requisitioning new connections the excavation and subsequent reinstatement work for new connections is often carried out by the developer itself, resulting in the company's requisition charge being calculated on the basis of lay-only costs. Because of this some companies are choosing to exclude excavation costs when calculating the asset payment for self-lay provision, i.e. calculating it on the basis of a percentage of lay-only requisition costs rather than the full costs of providing the works that will be adopted.

Where the water company undertakes the excavation works, it only charges a percentage of these costs to the developer, with the rest being paid for by existing customers through the income offset. Whereas if an SLP undertakes the excavation and reinstatement (either directly or via by its own commercial agreement with its developer customer), we have found instances where it does not receive an asset payment for this part of the work. This does not create a level playing field for self-lay providers to compete.

We are not suggesting that water companies should start charging for excavation and reinstatement services where they do not carry out this work. However, while they continue to offer asset payments and income offset, the Charging Rules require that water companies ensure that they apply a fair and consistent methodology that does not discriminate between whether the developer chooses the requisition or self-lay option.

We therefore expect water companies to ensure that the costs they include in the calculation of their income offsets and asset payment are fair and non-discriminatory.

Lack of clarity around charges and when they apply

Water companies typically split the costs of providing design services across a number of different charges including administering the design, vetting the design, checking the design, as well as the charge for the actual design itself. Absent worked examples, it is not always clear which charges apply in circumstances where a self-lay provider supplies its own design, as compared to when it purchases a design from the water company.

This lack of transparency makes it difficult for self-lay providers to accurately estimate the charges they will face and therefore enable them to identify which is the most cost-effective option for them.

The lack of transparency can also arise when water companies seek to recover the costs of contestable and non-contestable work through a single charge, particularly where it is unclear as to the size of the non-contestable element. The costs of requisitioning a water main and making a connection should be recovered through two separate and clearly identifiable charges to ensure that developers and self-lay providers can estimate the charges they will face.

The Charging Rules require that water companies publish their charges with sufficient additional information or explanation to make clear what services are covered by each charge, such that a developer or other customer is able to confidently work out a reasonable estimate of the charges they will face if they know the relevant parameters of a development.

We therefore expect water companies to provide sufficient explanation with their charges, including worked examples, to ensure that they are clear and transparent, and that developers and self-lay providers are able to identify the costs they will face in typical scenarios.

Lack of cost reflectiveness

The charges for providing design services vary significantly across water companies. Some companies appear to be providing their design services for free in certain circumstances, whereas others are charging over £1,000 for what appears to be an equivalent service.

Under the Charging Rules, charges should reflect the costs of providing the service in question. Although there may be some regional variation in the level of costs incurred when providing design services, we consider that the range of charges that we have identified is too large to explain this.

We therefore expect water companies to review their charges for design services and other contestable services to ensure that they accurately reflect the costs of the activities undertaken in providing the service and that only those activities are included that are genuinely necessary to provide the service. Where we identify that a company's charges are significantly different from those charged by other water companies, we may seek further information to ensure that those charges can be justified.

Absence of sufficient margin

Our assessment of the charges faced by developers and self-lay providers for design services suggests that in some cases there may be insufficient margin to enable self-lay providers to compete effectively with water companies in the provision of design services.

In these cases, when the design checking and other charges that water companies impose on self-lay providers are deducted from what the water companies would charge to provide the design, the amount of margin left to cover the self-lay provider's own costs of design work is often less than the amount the water company charges to provide this service (and in some cases is zero). This suggests that a self-lay provider that is as equally efficient as the water company would not be able to compete to provide these services.

It further appears that there may be similar concerns in relation to the margins available for self-lay providers when competing against the requisition charges of water companies to provide new connections, though we would need to obtain further information in order to form a more definitive view on this.

Under competition law, dominant providers have a special responsibility to ensure that their conduct does not distort competition. This includes ensuring that their pricing ensures that there is sufficient margin between upstream charges and downstream prices to enable equally efficient competitors to compete in the provision of services that are based on the upstream inputs provided by the dominant company. The Charging Rules also require that charges be set in accordance with the principle that they should promote effective competition for Contestable Work.

Water companies should therefore review their design prices to ensure that when their administration, vetting and other design costs are deducted, there would be sufficient margin for a self-lay provider to provide its own design.