

Charging arrangements for new connection services for English companies: comparative analysis and consultation

Severn Trent response

June 2020

Summary of response

We welcome the opportunity to respond to the consultation on connection charges for English companies.

We are wholly committed to setting charges which are simple, predictable, transparent and fair. We recognise that there are opportunities to make life easier for our developers who operate in different areas of appointment. In principle, we support Ofwat's aims of making charges within different areas more easily comparable across the country. However we also recognise this may prove to be a difficult undertaking as we explain in our response.

While there may be some "quick wins" that can be achieved if we strive to use the same terminology for the same activity, we think that more detailed work may be required to understand the underlying costs, and the reasons for the significant differences between companies. We are not sure that an industry-led body would be able to lead this work without regulatory change, potentially in the form of a licence modification.

We also think the introduction of DMEX could help address some of the concerns. This is because the way in which companies communicate their charges and provide the best value can be a differentiator for the Developer Measure of Experience (D-MeX).

As Ofwat's analysis highlights, there is less variation in the total bill for similar developments than there is between the individual charges that developers have to pay; this suggests that companies are bundling the service in different ways. A cross-industry audit, commissioned by Ofwat, could be a first step towards reducing these differences. This would highlight whether there are in fact any concerns in relation to cost-allocation, and make recommendations which all companies could act upon. If this does not narrow the price differential, then Ofwat could consider whether a regulatory change is required to deliver a common approach to pricing.

Specific comments in respect to each of the questions are contained within this document. Should you require any further information please do not hesitate to contact me.

Kind regards

Shane Anderson
Director of Regulation and Strategy

Response to detailed questions

Q1: Do you agree with our proposal on common terminology and the way we propose to implement it? What do you think would be the impact of harmonising terminology for charges for new connection services?

We agree that harmonising terminology could improve the comparability of charges between companies and doing this could be a “quick win” for the industry. In our view there should be no adverse effects from taking this step.

Q2: Do you agree with the definitions in the glossary (Appendix 1)? Please tell us what definitions you would amend, remove or add.

We agree with most of the definitions. We do offer the following suggestions :

“Charging Year”- we would suggest that the word ‘calendar’ is removed from the definition so it reads “Charging Year” therefore reflecting the financial year for the period 1 April in a given year to 31 March in the following year.

“Long Length”- The descriptive element is useful however the reference to 4 meters being the defining point for classification as a long length will not be the case industry wide. Our current methodology utilises 5 meters or more as the classification for a long service connection. It may also be useful to determine a cap for the maximum length of a long connection, because the longer the connection the greater the likelihood of additional challenges and associated costs - for example, multiple traffic management.

“Short Length”- As mentioned above further analysis may be useful to determine the short and long length classifications because this is likely to differ between companies.

“Small Company”- We would suggest that this reference be amended or removed because it could confuse developer customers to whom this term does not apply. 'New Appointees' is a more customer orientated description.

Q3: Do you agree with the proposal to set out explicit expectations on the presentation of worked examples? What do you think would be the right level of detail to be required?

The range of examples in the [2020-21 requirements](#) represent a reasonable range of sites and should enable customers to form an estimate regarding the likely cost of their development. Difference between stylised examples and actual sites are inevitable, but it is important that the requirements are explicit about the costs that should be included and excluded from the calculations.

Depending on the approach that companies take to their charges, some costs may be wrapped up within an average rate – for example, traffic management could be spread like an overhead to arrive at a more simple scheme, or stated as a separate service for those sites where it is required. Whatever approach has been taken, it will aid comparability if companies state this in the worked examples.

Comparing the requirements from IN19/05 with the [worked examples that we already present](#), we think it would be useful if Ofwat could be more explicit about metering costs, traffic management and water for

construction which is typically required on building sites. In addition, the self-lay scenario needs to be more specific, because there are many variations in self-lay arrangements; in some instances SLPs find it more expedient for Severn Trent to undertake part of the work, while in others they will undertake all of the contestable activity.

We note that infrastructure charges are outside the scope of this consultation, but we include them with in our worked examples because we think it is more transparent about the total cost that customers will have to bear on a typical development.

Q4: Please highlight any substantive areas of our analysis you think are missing or could be improved.

Overall, we think that the approach is reasonable but – as we note above – it is important to be specific about the costs that are included or excluded from the typical examples. Part of the difference may relate to items that are wrapped up within an averaging approach for some companies and not for others. We think it could also be helpful to validate the calculations as well as the data collection, to test whether companies recognise the overall costs for typical sites that have been quoted in the report.

Q5: What do you think are the reasons for the differences in charging levels? Do you think these differences are a problem? Please provide evidence to support your views where possible.

At a high level, we agree that the apparent differences between companies appear very wide for an activity that is fundamentally the same wherever it is undertaken. We think there could be several potential drivers.

Firstly, as we discussed in Q3 there may be differences in the way that companies are bundling together the services that are required to deliver the connections. Ofwat's analysis does suggest this, because the range between line items (e.g. the unit cost for mains laying) is higher than the variance at notional site level. We think that further analysis of the costs that are charged separately could narrow some of these differences.

During AMP6 we implemented a charge per pot approach, in order to make charges simpler for developers. This approach was put in place following feedback from our developer customers, but it involved a higher level of averaging than our current method (for example, the typical mains lengths and material requirements for each plot connected). The result was a very simple and predictable charge, but one which was very difficult to compare against other companies because of the degree of aggregation. This kind of effect may be occurring to some extent in the comparison that Ofwat has undertaken.

Secondly, the differences may relate to contracting arrangements where some of the activities are outsourced. Within the line item analysis, we could be observing contractors accepting low unit rates on one item because they are making better margins on others.

Thirdly, there may be differences in the way that companies allocate shared costs and overheads within the charges.

Finally, some cost differences will be the result of efficiency and it is important that companies do charge in line with their own cost, rather than an industry average. But even when all these factors are considered, the level of difference in the analysis does seem a little too large to be the result of efficiency alone, so we think some further verification would be helpful.

Q6: Do you agree with our proposal to modify the Charging Rules for New Connection Services to explicitly include cost-reflectivity in the general principles? What other measures, if any, could be put in place to provide greater assurance that water companies' charges are cost reflective?

We think that a charging rule along these lines would do no harm, but we do not think that it would have any impact on the differences that Ofwat has observed in this report. Companies are very much aware of their existing obligations in this area and we believe that all will consider that their charges are *already* cost reflective – notwithstanding the differences in Ofwat's analysis.

If Ofwat has concerns about the way that companies are allocating costs in this area, it might be productive to undertake a cross-industry deep dive – similar to that which was undertaken for retail costs prior to PR14. This would provide some recommendations on how the industry could converge.

Q7: What do you think are the benefits and disbenefits of having common charging methodologies? Do you think companies should adopt common methodologies?

There could be benefits to a common charging approach, because this would make it easier for developer customers who work across the country to know what to expect and they would not have to learn the nuances of each company's approach. It would also make for easier comparisons between companies. However, the rates would still differ because each company would need to reflect its own costs in order to avoid being anti-competitive, not an industry average.

A concern with common charging structures is that - because they facilitate comparison - they also enable convergence, and this may give rise to suspicions of collusion. Stephen Littlechild raised these concerns with regard to the energy market when Ofgem decided to limit the number of different tariffs that energy retailers could offer. This was done with the best of intentions – reducing customer confusion and enabling them to make choices – but limiting the differences between charges may actually reduce choice and competition.

Before AMP7, incumbents were not in competition with each other - self-lay providers and new appointees competed with us in each area, although for incumbents developer services was simply a matter of cost-recovery rather than profit growth. But the introduction of the D-MeX means that there is now comparative competition between companies, meaning that companies will seek to earn rewards or avoid penalties. Clear charges – and lower charges - are two ways in which companies could seek to differentiate themselves from the rest of the industry and earn better D-MeX scores. This makes alignment a more complicated issue.

Q8: Do you agree with the high-level scope of the proposed New Connection Charges working group? Please tell us your views on the proposed working group, including whether Ofwat should make the work mandatory, for example through a change to our new connection rules.

We think that the industry can come together to agree common terminology and presentation. However, as we note above, companies are concerned about compliance with regulation and competition law in this area. This, together with the D-MeX comparative competition, could make it difficult for an industry-led body to align on common approaches to pricing and charging frameworks.

We would not be comfortable exchanging information with a working group made up of our competitors as this could be seen as being anti-competitive. We note the examples of industry collaboration within the

consultation. If Ofwat wants a similar arrangement to operate in the water industry we think this would require a regulatory change, possibly in the form of a licence modification; this is what happened in the electricity sector. We are not sure that a change to charging rules would be sufficient.

We would favour a cross-industry audit or study commissioned by Ofwat as a precursor. This might highlight areas where a more consistent approach would be beneficial – or provide reassurance that charges were in fact cost-reflective and cost allocations were broadly satisfactory (as happened with the cross-industry audit of retail before PR14). An industry working group (including Ofwat) could work alongside whichever contractor is appointed to undertake this work and provide guidance on the technical issues concerned.