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Dear Ofwat

RE: Monitoring and reporting for new appointees – a consultation

I am writing to you on behalf of independent Water Networks Limited (“IWNL”), part of the BUUK Infrastructure Group of companies, in response to the March 2021 consultation which sets out Ofwat’s proposed approach to monitoring and reporting arrangements for new appointees and variations (NAVs). In addition to the general comments set out in this letter, we have provided responses to Ofwat’s specific consultation questions in Appendix 1. I can confirm that this response is not confidential.

NAV licensees have already forced incumbents to make significant improvement to the standard of services that they provide to developers and new connections. These have a substantial benefit to the wider UK economy, but there is more that needs to be done, by both Ofwat and incumbents, to release the significantly better standards and associated benefits already delivered in other utilities. Utility connections are the life-giving arteries of any new development. They link users to the regional and national networks providing essential services for energy, water, and communications. Too often it has been a struggle to get these development arteries in place at the right time and exactly as needed. Over the past 20 years, however, the competition and choice offered by independent providers has meant that developers are no longer wholly dependent upon their regional network utility operators to meet their connection needs. Market liberalisation has fostered a new industry focused on meeting developer needs for fast and efficient utility networks on their sites. At the same time the complexity of utility requirements has grown as has the demand for speed. Such is the growth of this focused industry that most new gas and electricity

connections are now provided by independents. This is in stark contrast with the water industry where incumbents continue to provide the majority of new connections directly or indirectly, through ICPs, at a poorer level of service.

In stark contrast to other market liberalisations, however, the rise of competition in connections has, so far, been a quiet revolution for new developments. There has been none of the boom and bust of other liberalisations, with a rapid rise of new entrants, followed by failures of many and an equally rapid market concentration. Neither have there been reports of falling service standards or hidden costs.

As barriers to competition have reduced independent network providers have built a substantial market presence. In 2019 more than 300,000 gas and electricity connections were provided by independents. Set in context the additional 159,000 gas connections provided by independents was three times the size of the total growth in gas connections, and 150,000 independent electricity connections was 130% of the year's total increase in electricity connections. It is clear that independents competing with each other now dominate the markets for new network connections, including some of the UK's most iconic new developments such as Media City, Kings Cross, and Battersea Power Station. Independent Gas Transporters now serve more than 2.3 million UK users; a million more than in 2010. This makes them now of roughly equivalent scale in terms of connections to either Wales and West Utilities or Northern Gas Networks, with more than 10% of all new and old connections. The market presence of Independent Distribution Network Operators for electricity connections grew ten-fold between 2010 and 2019, from 50,000 connections to 780,000. This level of maturity in independent networks has not yet developed as the Water industry has been slow to facilitate the required level of innovation and change. Only since the recent full implementation of PR19 and Ofwat's support to the liberalisation of the new connections water market has there been an increase in growth in the independent water networks. Water customers are yet to see the level of benefits that now exist in the energy market. IWNL is committed to ensure that our customers and the wider industry do see these long-term benefits.

This is further reinforced as the UK faces a significant housing shortage in the face of a growing population. The Government also has ambitious plans for rapid development, not only for new homes, but for hospitals and businesses. The coronavirus pandemic of 2020 has reinforced the urgency of these plans, because development has been given a central role in the recovery from the pandemic and in plans to improve ailing productivity levels after Brexit

Independent connection providers innovate in way that incumbents tend not to. This is because they are exposed to very different commercial and competitive pressures, as outlined above with a quite different commercial focus. An independent operator's reward comes through efficiencies. To achieve this, they may choose to work across multiple utilities. As a result, some independents are increasingly developing true "multi utility" propositions to include heat, water/sewerage and/or fibre. The immediate commercial benefit is that the developer (and the providers building the networks) receive a bundled offer, from a single point of contact, for the adoption of multiple utilities on the same site. This produces obvious operational benefits by unifying quotation, design approval, land

acquisition and commissioning processes across multiple utilities. It can also produce a commercial benefit in that adopters can consider offering a “package” asset value to reflect the overall economics of the scheme.

IWNL is already focused on ensuring that it provides an excellent service to all of our customers. In general, therefore, we are supportive of the proposals presented in the Ofwat consultation to increase reporting for larger NAVs. We understand the drivers of the changes Ofwat is proposing and are supportive of its approach. We recognise that the proportion of water and waste customers served by NAVs is growing and that this necessitates a requirement for greater reporting to allow Ofwat to monitor the evolution of the market. However, we would note that these requirements should not directly mirror equivalent incumbent water company requirements as this would be disproportionate given the role of NAVs and are likely to restrict the further growth and the long-term benefits of independent water networks.

IWNL currently already collect comparable data to incumbents on customer performance, network performance, financial performance all supported by appropriate governance and assurance processes. Our Networks benchmark very well when compared to incumbents and we are committed to continue to provide an excellent service to all of our customers. We also recognise that this information would be beneficial to Ofwat when setting future price controls as it provides an insight into the potential best in class performance for incumbent network operators. However, there is a cost in providing this enhanced information to Ofwat which would need to be offset in the current regulatory arrangements. We believe that the change in the reporting requirements for NAVs should be accompanied by a review of the existing market framework and its ability to facilitate the growth in independent water Networks and the benefits it brings to all customers.

This is particularly relevant to the process that currently is used to determine the granting of NAV licensees. This remains the single biggest barrier to further growth in the NAV market and is restricting NAVs from competing fairly with incumbents. Furthermore, currently NAV's are often required to report on a licensee level which is disproportionate when compared to incumbents, both in relative and absolute terms. There is no statutory requirement for NAVs to report at this level and we believe it is appropriate for most reporting requirements to be focused on an existing incumbent licensee level¹. This would require NAVs still to provide much more disaggregated information when compared to incumbents, but we recognise and accept the potential wider benefits to customers.

¹ We recognise that it would be beneficial to Customers for NAVs to continue to provide some (financial) confidential information at a NAV licensee level whilst it is not appropriate to provide the reporting of some services (customer service) at a level disaggregated beyond the NAV company level.

We look forward to working with Ofwat and other market participants to make these necessary changes happen. Please do not hesitate to contact me if you have any further questions.

Yours Sincerely,

Keith Hutton
Regulation Director (Heat, Fibre and Water)

Appendix 1: Responses to specific consultation questions

Q1: Do you agree with the purpose and objectives we have set out? Should we consider other factors when developing our monitoring and reporting approach?

The purpose and objectives set out in the consultation align to Ofwat's statutory duties and therefore appear to be appropriate and reasonable. We also welcome the specific reference within the consultation to Ofwat's objective of ensuring that its "regulation of, and interactions with, NAVs are proportionate to the risks to customers and size of NAVs". However, IWNL believe that the review of the change in the reporting requirements for NAVs should be accompanied by a review of the existing market framework and its ability to facilitate the growth in independent water Networks and the benefits it brings to all customers.

The current Ofwat NAV licencing approval process remains the most significant blocker to IWNL competing fairly with incumbent water companies. We recognise that it is an ongoing statutory requirement on Ofwat to licence NAV networks on a site-by-site basis but maintain that further improvements to this process are possible within the current legislative framework. The House Builder's Federation (HBF) is the trade body, representing 80% of house builders. They have a group, Water Matters, that focuses on delivery of water infrastructure, which includes competition. House builders are clear that small sites, which make up most of the market, have a 28-day mobilisation period. Many of them have been clear to IWNL that they cannot risk completion dates of houses when their selection of a NAV is dependent on the granting of the NAV licence. They do not have this risk if they appoint the incumbent or an SLP with incumbent adoption.

We also note the importance that should be attached to Ofwat remaining mindful of the need to ensure proportionality in any work it progresses regarding revised monitoring and reporting of NAV performance. Ultimately, we believe that proportionality should be an overriding principle that informs Ofwat's decisions in this area. In this respect, we note the vast difference between the role of NAVs as compared with that of incumbent water companies, and the relatively lower risk that NAVs pose to the delivery of desired end customer outcomes. It is therefore important to recognise that any additional reporting requirements imposed on NAVs should not directly mirror the equivalent reporting requirements that incumbents must comply with. Such an approach would be disproportionate to the size and role of NAVs as well as the associated level of risk that they pose. If unduly onerous reporting requirements are placed on NAVs it could compromise NAV commercial sensitivities and / or unintentionally restrict NAV market growth.

We also have identified that incumbents do not have the same proposed obligations as NAVs to make their full annual reports to Ofwat publicly available to all customers. We recognise that some incumbents do publish this information voluntarily. This would aid transparency of service to NAVs and to enable NAVs to compare their standards of service more accurately to each of the incumbents. We recommend that incumbents are also required to make their reporting to Ofwat publicly available, to at least all embedded Network providers (including NAVs).

Q2: To support our purpose and objectives, do you agree with the principle of strengthening reporting requirements for all NAVs that are distinct from those for incumbents?

We understand the drivers of the changes Ofwat is proposing and are supportive of its approach. We recognise that an increasing proportion of water and wastewater customers are served by NAVs and that this necessitates a requirement for more reporting to allow Ofwat to monitor the evolution of the market. However, as outlined above, we would note that it is important that these requirements do not mirror incumbent reporting as this would be disproportionate to the potential impact NAVs could have on the overall market.

We also recognise that there are some statutory weaknesses within the current NAV licencing arrangements that Ofwat are trying to address in tightening the ongoing reporting requirements on NAVs. There are alternative approaches to addressing these, without requiring changes to statutory licence conditions, which IWNL are supportive in implementing. For example, we recognise the need to formalise much of the NAV market arrangements in a code of practice, similar to the Retail market operated by MOSL. This would address many of the market visibility issues that Ofwat are seeking to tackle, whilst also formalising the market arrangements. Further, as in the Energy market and Water Non-household Retail Market, this could be used to implement a system that enables the transfer of NAV customers to another entity in the unlikely event of a NAV company financial insolvency. IWNL are willing to work with other NAV licensees and incumbent water companies to implement a suitable market arrangement.

Q3: Do you agree with the principle of introducing proportionate reporting requirements that are based on a 'tiered' approach? What should be the basis of these tiers?

We agree that the approach toward regulating NAVs should be tiered, recognising the differences between the various market participants. In this respect, as noted in the consultation, the annual turnover of some NAVs is in the millions of pounds while other NAVs only operate one or two sites. We therefore agree that placing the same reporting requirements on these entities would be disproportionate.

We recognise that IWNL would fall into the top reporting tier and agree that this is appropriate. While we do not have strong views about the best way to derive the respective tiers for NAV reporting, (e.g. number of connected customers or annual turnover), we note the importance of ensuring that any measure is objective, easy to quantify and comparable across entities.

Q4: Do you have any comments on how we should approach the information we collect from NAVs?

We recognise the potential benefits of aligning Ofwat's approach in monitoring, assessing and presenting NAV information with its approach to the equivalent processes established for incumbent water companies. As appropriate, this could extend to the inclusion of data on NAVs in Ofwat's annual publications on financial resilience and service performance. However, if Ofwat decides to align these approaches it should be cognisant of three key

issues. First, it will be important to ensure that any metric used to compare NAV and incumbent performance is objective, easy to quantify and comparable across entities. Second, Ofwat will need to have regard to the proportionality of the requirements that it places on NAV, recognising their role within the water and wastewater sectors, as well as the risk that their operation poses to the delivery of desired customer outcomes. Finally, consideration should be given to any potential commercial sensitivities associated with the proposed publication of NAV information. Ofwat should weigh up the benefits of improved information transparency alongside the potential costs to the NAV.

Q5: What are your views on how the quality and transparency of financial information in small company returns could be improved? How could this vary by tier?

To date, we believe that IWNL has taken a robust approach to the development and assurance of our annual financial reports; implementing appropriate processes to secure effective quality control and providing sufficient information to the IWNL Board to ensure the performance of the business is transparent and fully understood.

In line with this, we think any NAV that qualifies for the highest regulatory tier should be required to provide evidence of the processes that have been established to collate, review and analyse the information comprising their annual report, and demonstrate that supporting quality control provisions are in place. In addition, we recognise the benefit of placing accountability for company performance in the hands of the Board and therefore consider that those NAVs in the highest regulatory tier should also be required to submit a statement of Board assurance alongside their annual report.

Q6: Do you agree with our proposal to introduce an annual narrative requirement for NAVs subject to a company-based assessment? Should further information be included in the small company return?

We note Ofwat's proposal to include a requirement for NAVs to compare their latest annual outturn figures with forecasts provided in previous years, alongside a narrative explaining any material variances. We understand that the rationale for this requirement would be to allow Ofwat to better understand the financial health of the NAV as part of the annual review of the company-based assessment completed for licensing purposes. However, we do not consider this to be a representative or appropriate measure of NAV financial health.

In this respect, the performance of a NAV in delivering against its forecasts is, to a large extent, outside of the NAVs control as it is influenced by several exogenous factors. If they do not perform in line with the forecasts submitted at the start of the financial year, this may be an indicator that the business did not grow as fast as we anticipated but, in and of itself, is not an indicator of any potential issues associated with the financial health of the company. Indeed, it would be difficult for us to identify, explain and quantify the drivers that led to a difference between forecasts that were set at the start of the financial year and the actual outturn figures, given the number of variables that would affect this e.g. housing market activity and competitive conditions within the market. Rather, we consider that an accurate representation of financial health will only be attained via an assessment of the underlying financials of the organisation.

In this respect we think there are three key indicators that Ofwat should use in its assessment of a NAVs underlying financial strength and these should be used in the annual comparison of outturn to forecast.

- Firstly, the level of Debt, the grading of this debt and associated company guarantees.
- The underlying profitability of a NAV and the speed of which NAVs are expected to become profitable.
- The current and forecast customer cost to serve.

Q7: Do you agree with the principle of a consolidated APR that is accessible to all relevant stakeholders? For some measures, may another format be more appropriate?

We recognise the value of providing transparency to the market regarding the performance and financial resilience of NAVs; and note this could be of particular benefit to developers seeking partners for new sites or incumbents keen to attain insights into NAV operation. However, it is critical that the desire for transparency is effectively balanced against the commercial sensitivities inherent within the NAV market. This goes to the heart of fundamental differences between NAVs and incumbent water companies with respect to their respective operations in competitive and monopoly contexts.

In the absence of full transparency regarding Ofwat's expectations of the content of the consolidated APR accessible to all stakeholders, it is difficult to comment meaningfully on this element of Ofwat's proposals. Once we have clarity in this area, we will be better placed to comment on any potential commercial sensitivities that could be at risk.

Q8: What should the APR include as a minimum and which existing performance measures may be relevant to include?

We agree that NAVs should provide similar and proportional measures of customer service, leakage, environmental performance and network performance as incumbents currently provide. However, we do not believe that it is proportional for NAVs to provide this information at a NAV licensee level. This currently requires NAVs to report at a much more detailed level than incumbents. We believe it would be proportional for NAVs to generally report at an aggregate level for each incumbent licensee area. This would enable comparison on relative performance without placing a disproportionate regulatory burden on NAVs. We do not believe there is any statutory requirement for NAVs to report this information at a licensee level.

For customer service, IWNL use our own internal framework, based on elements of the C-MeX, to measure and benchmark IWNL customer service performance, including comparisons to incumbent water company performance. While we recognise the merits of such an approach, we have a slight concern that fully replicating the provisions of the C-MeX for NAVs could be overly prescriptive. We also have concerns about the timeframes associated with the implementation of these requirements; while we may be able to

implement changes that would enable us to report against a measure that mirrors C-MeX for the period 2022-23, there is less scope for us to accommodate these changes in the current 2021-22 reporting period. This information can only be provided at an aggregate company level.

Current regulatory provisions make it very difficult for NAVs to offer similar services for economically deprived and vulnerable customers to those offered by incumbents. In line with the 'no worse off' principle, we believe that NAVs should be able to offer comparable social tariffs to those provided by incumbents. However, this does not fully account for the range of social tariffs offered by incumbents and the difficulties that NAVs would experience in seeking to match these. In addition, if we were to establish an IWNL social tariff, this could lead to some instances where we would actually breach the 'no worse off' obligation for individual customers. At present, we do not have clarity on the way that other NAVs treat these issues but we hope to attain greater insights in this area via the NAV Bulk Supply Charging forum that has been established.

Q9: How may reporting requirements differ between NAVs and at what level should performance information be reported?

Our preference would be to generally report information on an incumbent water area basis. However, we note that care would need to be taken in making comparisons between the respective performance of the incumbent and that of the NAV given that this would effectively disadvantage the NAV. In this respect, incumbents are required to report performance at an overall company level and this information is, by its very nature, more aggregated which facilitates the averaging out of any anomalies or outlying data points. In contrast, the increased granularity of information provided by NAVs when reporting on an incumbent water area basis, will give greater prominence to any instances of poor service and will have a corresponding higher impact on the overall performance scores. This is particularly true of wider services and we therefore think it is important that some measures, such as customer service, are reporting at an aggregated customer level. Further, any public reporting and comparisons made between the service offered by incumbents as compared to that offered by NAVs is made at the same level of aggregation to avoid unintentionally misrepresenting NAV performance.

Q10: What should our approach be for ensuring there is sufficient assurance relating to the information provided by new appointees in their annual returns?

We do not consider that it would be reasonable to place a requirement on NAVs to engage a third party to assure annual returns. In this respect, given the relative size of NAVs as compared with incumbent water companies, we think such an obligation would be disproportionate to the associated risk. Rather, we consider that a requirement to provide a statement of board assurance and mitigations taken should provide sufficient comfort to Ofwat regarding NAV performance from a financial resilience and customer service perspective.

Q11: What should our approach be in terms of the board leadership, transparency and governance of new appointees?

Following publication of Ofwat's position paper "Putting the sector in balance", we completed a comparison of internal IWNL governance and assurance processes against Ofwat's stated expectations. The results of this assessment led to changes in our approach, and our supporting governance and assurance processes are now more aligned with the expectations of incumbent behaviour that Ofwat set out. As a result, our reporting includes a board-level statement assuring the accuracy of IWNL regulatory information and supporting data. For example, IWNL have now appointed an independent chairman, and implemented full company board assurance processes.

We note Ofwat's view that companies should provide a supporting narrative demonstrating the robustness of governance provisions and recognise the value of this. We would therefore be happy to incorporate a narrative in the 2020-21 annual report that provides an overview of the governance and assurance arrangements that we have established. We note however that some of the requirements in Ofwat's position paper are not directly applicable to NAVs, for example third party assurance, and therefore do not consider that it would be reasonable to require NAVs to be subject to associated requirements in this area.

Q12: Do you have views on how and when changes to reporting requirements for new appointees should be implemented?

While we think it will be possible to incorporate some elements of the proposed approach presented in the Ofwat consultation within the 2020-21 annual report, others will involve longer lead times and it will not therefore be possible to implement all of the changes until the 2021-22 or 2022-23 annual report. Once we have clarity regarding Ofwat's expectations regarding future NAV reporting, we will be able to reach a more informed view on the lead times associated with delivery against these requirements and can provide insights on which elements we are able to report against as well as the timeframes associated with them.

We would welcome the provision of further clarity regarding Ofwat's expectations of the reporting process and note that where NAVs are given sufficient time to consider the requirements, identify any necessary changes required to collect the data, and then collate the information proactively this would be particularly valuable.

IWNL currently completes its financial reports on a calendar year basis (January to December) rather than a regulatory year basis (April to March). We would welcome amendments to the Ofwat reporting requirements that allowed financial accounts to be submitted on a calendar year basis as this would avoid the duplication of effort in producing two sets of accounts. If this amendment to the provisions were to be made, it would also effectively allow three extra months to produce and sign off the accounts internally prior to the required July submission.