Updating Ofwat's charging rules – consultation response July 2021

6 July 2021

Q1: Do you agree with our proposed rule changes? Please offer alternatives if you think they would better achieve our intentions.

1.1 We address each of the proposals in turn.

Changing publication dates

1.2 We agree with the proposal to publish fixed dates and are happy with the dates proposed for each of the three charging schemes.

Publishing Statements of Significant Change

1.3 We agree that it makes sense to be able to publish the statement of significant change and the charges scheme together. It would be beneficial to customers to see both documents at the same time if companies choose to publish their charging schemes earlier than the deadline.

Cost Reflectivity

1.4 We note that reference is made in the consultation to the consideration of long run costs in setting charges. We are unsure how long run is applicable to New Connections charges, perhaps except for Infrastructure Charges. The term "long-run" can be interpreted in several ways, and we would advocate having a precise definition to avoid each company using a different interpretation of what it means. This would be confusing for customers.

1.5 We believe that you are trying to find a way to balance cost reflectivity whilst avoiding cost volatility for customers. We propose that this could be aligned to the Infrastructure Charge methodology to look at forecast costs over a forward-looking five-year period, recovered over the expected number of jobs.

1.6 We recommend having further discussions with companies are required to understand the intent and find the right balance between maintaining a set of principle-based charging rules with consistent interpretation for the benefit of customers.

Consistent Terminology and using worked examples

1.7 We have been an active member of the industry working group established to consider the standardisation of terminology and worked examples. We believe that the output submitted to yourselves was a significant step forward in providing greater clarity and consistency for all market participants. We note that the terminologies and worked examples documented in the latest consultation differ from those submitted by the working group. We believe the recommendations presented by the working group provide greater clarity and consistency for our customers than those outlined in the consultation. We have been in discussion with Water UK on this subject, and they will be providing a more detailed response to this question on behalf of the companies involved.

1.8 We have discussed the output of the working group with our scrutiny panel and issued a customer newsletter soliciting feedback on terminology and worked examples. However, we note that the timescales for this consultation required swift responses. We have encouraged developers to respond to us or to send comments directly to you by the closing date for this consultation. Only two responses were received by us in time to be included in the Water UK consolidated response.

Where to issue rules on infrastructure charges

1.9 We agree that it makes sense to have all the developer New Connections charges in one set of rules, which makes it simpler for both customers and water companies. We support the proposal to have both the infrastructure charges and income offset rules moved from the charges scheme to the New Connections rules.

Income offset and connecting to existing mains

1.10 We agree with the proposal to amend the definition of income offset to include connections to both existing and new mains. We believe this makes it fair especially for smaller customer groups making home improvements who would otherwise not qualify for the income offset.

1.11 In table 1 of the consultation this adjustment is proposed to be made to the Charges Scheme Rules, but in Appendix 1, new rule 6 includes the Income offset rules as transferring to New Connections rules. Table 1 should be amended to make it clear that Income offset is also to be moved to New Connections charges.

Network reinforcement and NAVs

1.12 We are pleased that our request to Ofwat to include Bulk Supply agreements for NAVs to be added to the Network Reinforcement definition has been included, and we support this change.

Quotes spanning different charging years

1.13 Thames Water already explains the validity period on which quotes are provided and the transitional arrangements for when they span different charging years in our published charging arrangements each year. We have received feedback from our developer customers that our transitional arrangements are very clear and easy to follow. We are therefore happy with this proposal to embed this into the charging rules.

Q2: Do you agree with our proposed changes in Appendices 1, 2 and 3?

2.1 We have captured the key proposals in bold below with our comments on each one.

Appendix 1 table 2 proposed wording of new rules

2.2 We notice that in Table 2 the references listed refer to the wrong charging arrangements in some instances. For example, New Rule 1 first paragraph is a change to Wholesale Charges, but the reference column states ENCR instead of WCR. We also note that rules relating to Infrastructure charges and Income offset will need moving out of the CSR and adding to the ENCR.

2.3 New Rule 3 Cost Reflectivity. Long run costs need to be defined as it is open to interpretation and should be added to the glossary. See our comments in 1.4 above.

2.4 Rule 8 Network Reinforcement. The sentence “additional capacity in any earlier Water Main or Sewer” needs to be clarified or removed. We are unclear how a retrospective requirement can be accommodated in a forward-looking calculation. See our comments in Section 3.

Appendix 2 table 3 new and amended terms in our New Connection Rules

2.5 The list of terms in the Appendix is different to the one proposed by the working group. We would support the inclusion of all terms proposed by the working group subject to any changes proposed through the consultation.

Appendix 3 proposed information requirements

2.6 Worked example 6 provided by the working group was omitted from the consultation and should be added back in to give customers a comparison to example 5 (as example 4 relates to example 3).

2.7 The templates supplied by the working group should be included rather than these edited ones. They set out a consistent way to display the worked example and had columns to include the charges that the incumbent would make to an SLP or NAV so that a developer could see the costs of choosing an alternative provider. We believe that this is an important step which helps promote the objectives of supporting effective markets, providing useful transparency to developers to inform their decision-making.

2.8 We support the use of these examples as a common requirement for charging, provided that the SLP and NAV equivalents are re-instated and subject to any additional feedback from stakeholders through this consultation.

Q3: We seek your views on our clarification of the five-year rule. In particular, we would like to know of any potential implications for charges and customer bills from companies following our interpretation.

3.1 We welcome Ofwat's desire to provide greater clarity and consistency to how balancing of infrastructure charge income and network reinforcement expenditure should be considered over time. However, we do not agree that the interpretation included in the consultation adds sufficient clarity to the setting of the infrastructure charges. We welcome the instruction that we should only be considering future periods when setting infrastructure charges and we will adopt this approach from this year going forward.

3.2 If Infrastructure charges are to be set based upon future anticipated costs, and APR reporting to only report on actual income and expenditure, we are unclear what value the APR is adding. Combining retrospective reporting in the APR, and charges based only on a forward estimate of expenditure means that comparison between the two becomes a barometer of our forecasting ability and any volatility within the new connections market. We are unsure what clarity the quote ascribed to the April 2017 consultation brings about the intention of the APR reporting.

*"If there a difference between expenditure and receipts in one year, customers will want to understand the reasons behind it and **want assurance the imbalance will be corrected in future years"** (emphasis added by Thames).*

3.3 This quote explicitly directs companies to adjust future charges to make up for any deficit/surplus in previous years, which is contrary to the clarification that this section was seeking to deliver.

3.4 If charges are set wholly based on forward looking forecasts, then this could mean significant under or over recovery on each individual year depending on the timing of large network reinforcement schemes as investment will not follow a flat profile. This could mean Developers being double charged for schemes that slip back one or more years as new information becomes available.

3.5 It is much less likely that a new scheme will come forward and be implemented in an individual year which was not in the 5 year forecast (meaning that Developers are never charged for it) There is therefore an asymmetric risk in this definition of Infrastructure charges that Developers will be asked to fund more in the long run than the actual level of network reinforcement delivered.

3.6 For example if a large value scheme that was expected in the first year of the five year look ahead (so formed part of the Infrastructure charge) was delayed and slips to the following year, then it would also form part of the infrastructure charge calculation for that year. As a result, developers could end up paying twice for the same element of reinforcement as there would be no adjustment for the fact that the costs were not incurred as planned in the first year.

3.7 For Thames Water's developer customers, the proposed change in methodology would result in a price increase. In table 2K of this year's APR we are showing that cumulative infrastructure charge receipts exceed Network Reinforcement costs incurred by £11.5m for waste. If we didn't include this when setting the infrastructure charge it would result in a price increase of c11% (this is the methodology change impact only and excludes any other factors that may change our forecast run rate). For Water the situation is reversed, and Network reinforcement costs exceed infrastructure receipts by £1.5m. This would have a smaller impact with a c2% decrease. Overall, this would equate to an infrastructure charge increase of c£30 per property based on the change to our current published rates.

3.8 We would like additional clarity, perhaps by the provision of a worked example, of how the requirement in Rule 8 on Network Reinforcement can be applied to setting the Infrastructure charges on a forward-looking basis. Again, this appears to be directing us to include a retrospective element to the charge.

"It also includes the additional capacity in any earlier Water Main or Sewer that falls to be used in consequence of the provision or connection of a new water main or sewer"

3.9 Taking into account all this, it seems to us that while Ofwat is clearly stating its *intention* that infrastructure charges should be forward looking, there are sections of the consultation that strongly suggest the contrary. We believe that Developer charges will increase in our region as a result of changing to a forward-looking methodology resulting in a shift in the balance of charges from end-customers to developers as a consequence of not re-balancing underspends.

Thames Water