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Ofwat
Charging
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By email: charging@ofwat.gov.uk

6 July 2021

Dear Ofwat,

Re: Consultation on updating Ofwat charging rules

Thank you for the opportunity to review and provide feedback on Ofwat's proposals to make changes to the charging rules it sets under the Water Industry Act 1991 for incumbents, specifically, the following rules:

- Wholesale Charging Rules;
- Charging Rules for New Connection Services (English Undertakers); and
- Charges Scheme Rules.

We have reviewed Ofwat's proposals and the draft text for modifications and additions to the charging rules and we append our responses to the consultation questions to this letter below. We note Ofwat's intention to publish responses to the consultation on its website and we give our consent to publish this letter and appended pages.

Should you have any questions in relation to this response you can contact me by email at: colin.fraser@yorkshirewater.co.uk. We look forward to Ofwat's subsequent engagement with the sector on this matter.

Yours faithfully,

[redacted]

Colin Fraser, Regulatory Strategy Manager

Yorkshire Water Response: Consultation on updating Ofwat charging rules (June 2021)

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

We agree with many of the changes proposed as although several are relatively minor, they add some further clarity to the respective charging rules for companies. Below we take each change proposal in turn and provide brief feedback.

Change 1. Changing publication dates for companies. We agree with the proposals as explained and the publication dates set. These changes remove any remaining ambiguity in respect of the latest dates' companies should publish their charges schemes and arrangements by. We would point out that the table presented in the document (Table 2: proposed wording of new rules) contains some erroneous references to Wholesale Charges Rules and English New Connections Rules. We would welcome the references being corrected for Ofwat's forthcoming decisions publication as the table format is a helpful way to present the changes being made.

Also, there is no reference to Wholesale Charging Rule 26 for 'small companies' which requires them to publish their Wholesale Charges nine weeks before the start of the period for which the charges will be imposed. Although we recognise new appointees do not presently serve many premises that are eligible premises for the business retail market, we believe rule 26 should also be updated to reflect a date in advance of the charging period to allow non-household retailers time to review and incorporate any relevant new appointee wholesale charges into their charges to their business customers that are served by the new appointees water or wastewater networks.

Change 2. Publishing Statements of Significant Change. We agree this minor change to information requirement A2 of the Charges Scheme Rules will allow companies to publish their Charges Schemes earlier than the 1st February date set out in the updated Charges Scheme Rules (rule 9), without affecting the timeframe for publishing the Statement of Significant Change.

Change 3. Cost reflectivity of new connections charges. We agree the introduction of a new rule (rule 30) into the English New Connections Charges Rules for charges to reflect the long run costs associated with providing the relevant service Is helpful. This gives some clarity for companies whilst retaining some flexibility over the timeframe they use to assess such associated costs based on their expenditure profiles and cost drivers. We do not believe this proposal is in conflict with the cost reflectivity principle that applies to all charging rules published by Ofwat.

Change 4. Consistent terminology. We agree with the intentions behind the proposals for common and clear terminology to be presented within, and English New Connections Charges Rules and then used within companies charging arrangements and schemes as relevant and Ofwat's references to the sector working group formed to develop the common set of terms and definitions. We note there continues to be some divergences between the sector's original list of terms and the proposals in the consultation (Appendix 2. table 3.). We understand Ofwat intends to engage in a further consultative exercise during July and we would be pleased to engage in further discussions via the working group with a view to reaching an agreed position on the contents of that finalised list of terms.

Through the working group and directly, we will continue to engage with our developer services customers on the use of the common terms in preparation for a finalised list, and make progress to transition from our legacy terminology for our associated publications beyond the charging arrangements.

Change 5. Using worked examples. Yorkshire Water presently uses a number of worked examples in its new connections charging arrangements and in its publication on the assessment of bill impacts between charging years. We know many other companies used worked examples as a way to effectively express seemingly complex and inaccessible charges related material to customers and stakeholders. These are, however, likely to be used inconsistently in scale and structure and the sector working group looking at terminology has also contributed to the preparation of a standard set of worked examples.

We welcome the guidance in the form of information requirements on how to set worked examples. We are supportive of the proposed minor addition to rule 11 and a new information requirement A2 within the English New Connections Charges Rules.

Change 6. Where to issue rules on infrastructure charges. We welcome the proposals to move the rules relating to the setting of companies' infrastructure charges from the Charges Scheme Rules to the English New Connection Rules, where they have more direct relevance. The provision of an additional explanation and signposting of which rules are issued under which powers of the Water Industry Act is also welcome.

Change 7. Income offset and connecting to existing mains. We note the proposals are about not limiting companies' provision of income offsets to premises connected to new mains, and to allow companies to provide income offsets where the connection is made to an existing main. We do not include income offsets in our new connection charging arrangements and have not done so since 2018. We have no objections to the proposal.

Change 8. Network reinforcement and new appointees. We agree with the proposals to update the English New Connection Rules to amend the definition of "network reinforcement" to include costs incurred by the incumbent when bulk service new appointees cause them. To be clear the recovery of network reinforcement expenditure through infrastructure charges is not limited only to those new appointees or other developer services customers whose sites cause the incumbent to undertake upstream network reinforcement.

In addition, we would welcome the addition of text to clarify that bulk metering at the boundary of the incumbents' network can also be classified at network reinforcement, under rule 5(o) *"i. Water Mains and such tanks, service reservoirs and pumping stations, and boundary meters to support bulk supplies of water or bulk discharge with a New Appointee, or"*

Change 9. Quotes spanning different charging years. We have no concerns about the inclusion of a rule to require companies to explain in their new connection charging arrangements the validity period of quotes for developer services work and the approach the company will take where the period over which a quotation is valid would cross into a new charging year. We have no issues with the text as drafted for new rule 49 as set out in consultation Appendix 1.

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

Appendix 1: Other than the specific comments outlined in our response to Question 1 above related to the proposed text for each charging rule detailed in Appendix 1, we have not further comments to make at this stage.

Appendix 2: As per our comments in our response to Question 1 above under change 4. we believe the terminology and definitions presented in Appendix 2 are a good substantive draft. We understand Ofwat expects to consult further with the sector in July on finalising the standard consistent terminology and we trust the outputs of this additional stage will conclude the work of the sector, stakeholders, and their representatives, and Ofwat.

Appendix 3: The proposed worked examples represent a good and varied list of typical development site scenarios. We believe these are sufficient to demonstrate how the key components of developer services work and new connections charges are structured by comonaies and can be used as a guide to changes in the level of charges from one charging year to the next. There may still be different interpretations made by companies at the detail level and in terms of how expansive their explanations of the core charge components listed may be. However, we believe this proposal represents a workable set of examples and the clarity provided by Ofwat will aid transparency and comparability for customers.

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 customers' bills from companies following our interpretation.

We have reviewed Ofwat's explanation of the 'five-year rule' and proposals around how any variance between expenditures and revenues associated with network reinforcement should be dealt with. However, we remain concerned that the approach as described may conflict with the principle of developers paying for expenditures incurred by incumbents to connect and supply their developments. The government guidance to Ofwat for water and sewerage connections charges [1] states:

"The general customer base should not bear costs in relation to new development and developers should not bear costs associated with enhancements to the existing network that are not a consequence of their new connection."

Firstly, Ofwat advocate that the end-of-period Developer Services Revenue Adjustment mechanism (DSRA) deals with under or over recovery of legitimate network reinforcement expenditures. We believe this approach seems to be moving away from the key principle laid out in the government guidance. The DSRA is expected to make some headway in rebalancing revenue variances to final determination allowed revenues based on differences in connection volumes, but it does this via the generality of customers, not developer services customers. Indeed there Is no direct regulatory mechanism we are aware of that would make adjustments to new connections charges to reconcile and remedy any under or over recovery of network reinforcement expenditures over the AMP7 period, whether that be in-period or end-of-period.

Secondly, forecasting future network reinforcement requirements driven by development and growth and the associated expenditures is understandably difficult. Local government development plans are often ambitious given they are somewhat pressured to align with national government housing plans and we often find they do not come to fruition as planned. Also, developments driving network reinforcement often come to our attention outside our consultations with local authorities and large developers after we have made forecasts of network reinforcement expenditures and set infrastructure charges. Not being able to reconcile back to the actual expenditures of the previous year or more we believe will hamper effective charging and possibly lead to as yet unseen impacts of competition.

When setting our infrastructure charges for charging years 2020/21 (set in late 2019) and 2021/22 (set in late 2020) we have factored in the actual expenditures for years 2018/19 and 2019/20 and refreshed our forecasts for the remaining years to 2022/23. We believe this still allows us to smooth the volatility of network reinforcement expenditures in individual years whilst avoiding fluctuations in forecasts that do not bear scrutiny when placed against the actuals.

By making an assessment based on Ofwat's clarification in this consultation based on using our historical forecasts and reforecasts, we would have already seen a material under recovery of expenditures from the first two years since the charging rule came into effect. Our forecasts would have sought to base cost recovery for expenditures of £6.1m of combined water and wastewater reinforcement work, yet our actuals show £10.4m has been spent on reinforcement. This equates to a 70% variance which we would not be recovering via infrastructure charges to developers, SLPs and new appointees. It Is noted

[1] Defra - Water industry: guidance to Ofwat for water and sewerage connection charges (2016)

that the % variances for water and wastewater would have been 46% under recovery and 120% under recovery respectively.

We appreciate this is only information from one company for two years, but it is indicative of the potential swings in actual expenditure compared to informed forecasting. A forecasting only approach may have as yet unforeseen effects on competition given some market participants focus on a single service. We consider SLP's and new appointees will generally pass on incumbent infrastructure charges in full to their developer clients, but for some they may have a different commercial model.

There is also variance in forecast connection volumes, which are Impacted by socio-economic and political factors far beyond the influence of water companies. This makes forecasts challenging and being able to rebase some years of the modelling of infrastructure charges on actual connection numbers Is useful to ascertain a more realistic run rate.

We believe the DSRA has value in reconciling material variances in connection volumes over the AMP7 period, but as a reconciliation mechanism it does not effectively address variances in network reinforcement expenditure. As a mechanism we find it too general and blunt for this purpose. Furthermore, the DSRA is baselined against connection volumes determined by Ofwat using data from the Office of National Statistics (ONS) not suited to that purpose [2].

We would welcome further discussion with Ofwat and the sector as a whole on the best way to move forward with a workable 5-year rule for the remainder of this AMP that ensures that developers fund network reinforcement in full and that charges are reflective of costs that developers drive. We would be happy to share with Ofwat further cost and revenue information against a range of modelled scenarios to help it to consider the possible impacts of the approach it proposes.

As an alternative, we would like to suggest at this stage a hybrid approach could be used remainder of AMP7 using 2 years of actuals and 3 years of forecasts for expenditures and connection numbers. Ahead of the AMP8 period we may see significant changes to the way costs are allocated and revenues are determined by companies from 2025 under Ofwat's indicative PR24 proposals around the provision of contestable and non-contestable services and the regulatory framework that supports this split approach.

Rule 28 as written does not specifically refer to the exclusive use of forecasts, but simply references that charges must be determined to "*... cover the costs of Network Reinforcement that the relevant undertaker reasonably incurs*". We have interpreted this to include the relevant costs we actually incur assessed over suitable long-term.

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[2] The ONS Household projections release (from September 20, 2018) states:
"*Household projections are not forecasts. They do not attempt to predict the impact of future government or local policies, changing economic circumstances or other factors that may influence household growth, such as the number of houses built. Household projections are not a prediction or forecast of how many houses should be built in the future.*"

In the context of setting cost reflective new connection charges under Ofwat's proposed new rule 30, to reflect the long-run costs associated with providing the relevant service, we consider we will use historical actuals, possibly with a contribution from forward-looking forecasts of costs and activity levels.