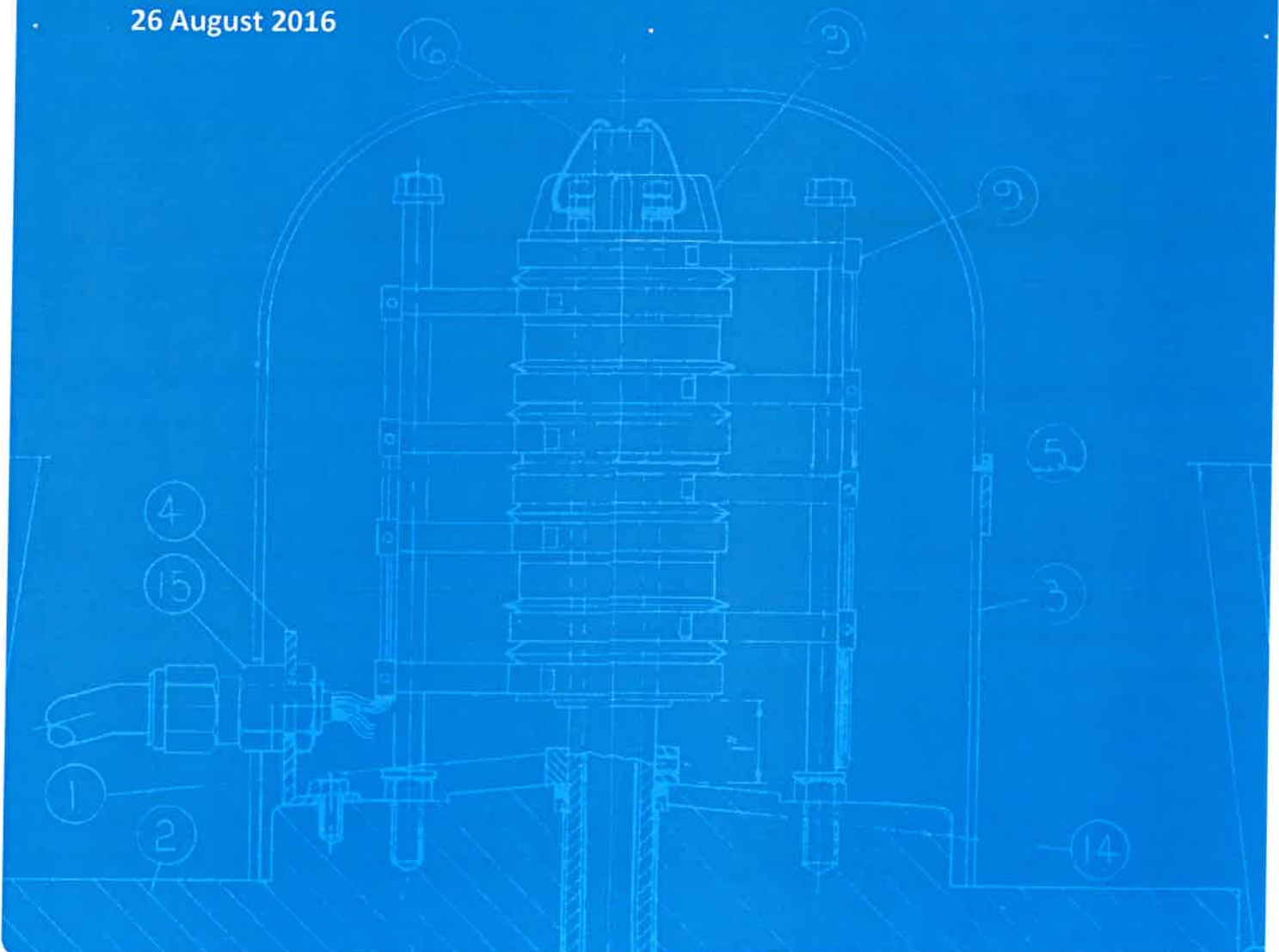


New Connections charging - consultation

SVT Response

Tony Ballance, Director of Strategy & Regulation
26 August 2016



We welcome the opportunity to comment on your proposals for new connections charging and appreciate that the discussions will continue at the September workshop at Water UK.

Charges for new connections, applied in the right way, have the potential to promote a fairer and more efficient water sector that will deliver real benefits to customers. We therefore welcome the emphasis on fairness and the flexibility afforded to companies under the proposed arrangements. These principles and the resulting proposals could help drive better planning decisions by allowing companies to adopt more innovative pricing strategies that incentive the right behaviour.

The use of the infrastructure charge to send locational signals is particularly positive and could help promote greater efficiency across the sector. However we are concerned about how subsequent proposals would interact with this rule and the boarder charging principles. We have therefore proposed some alternative solutions that we think will help deliver your objectives whilst still retaining the incentive properties such as locational based pricing.

Finally we note that the consultation does not consider that the proposals would impact other wholesale charges. However given that the proposals in this consultation will impact the price for different services to developers, it will inevitably impact the total revenues recovered from developers. Given the application of a single revenue cap at PR14, changing the revenue we collect from revenues from developers will inevitably impact the revenue we recover from other customers. For this reason we think the fast track timetable is unhelpful particularly since companies will be publishing wholesale charges shortly.

Yours sincerely



Dr Tony Ballance
Director of Strategy & Regulation

Q1 In light of our updates and clarifications, do you agree that we still retain the key features and approach of our March proposals?

In principle yes, however we do not consider that sufficient analysis has been dedicated to delivering Defra's objective of no changes between the balance of charges.

Q2 Do you agree with our updates and clarifications to our proposed rules?

Comparing infrastructure charge costs and revenues

We think it is reasonable to make a comparison between the long-term costs of reinforcing networks and the charges received.

The choice of a five year period for the comparison is possibly too short. The impact of new connections can occur over a prolonged period of time. A single connection to a local distribution network will drive no new investment – it may be the 1,000th connection, occurring after ten years of growth that creates the cumulative need. In this context, the wording of Rule 30 is potentially problematic – it is very likely that charges will relate to pre-existing issues to some extent (although these will have been caused by past requisitions). We therefore think it might be useful to consider a long term horizon, at least initially.

In the short term, there will be difficulty with the way that reinforcement costs are identified. Accounting separation has shown that there is room for wide variation between companies in the costs that are attributed to each activity. This means that it would be some time before this additional reporting regime matures. Therefore we agree that reporting on this variance should not be detailed until 2022 at the earliest.

We would not support a requirement for the average costs to drive the charge in a mechanistic way. Companies may have regard to their reinforcement costs when putting forward their own charging methods, but they should not be required to apply a particular approach. If applied before the end of AMP6, a mandatory average could have an impact on the balance between developers and other customers.

Q3 Do you agree that offsetting the infrastructure charge, rather than requisition charge, has merit? If so, when and how should this change be brought about?

We do not believe that offsetting infrastructure charges against developers' costs is the right approach.

Infrastructure charges should cover off-site reinforcement costs

One of the main aims of the changes that Ofwat has proposed in its new framework (page 20) is to remove the confusion about which charges should pay for off-site reinforcements. We support the move to use infrastructure charges alone for off-site costs – this will also help drive locational based pricing over the medium to long term. We consider that offsetting on-site development costs against off-site infrastructure charges could undermine the clarity of this new approach.

Discounting infrastructure charges will not be sufficient to replace the existing approach

Current infrastructure charges are a one off fee of £357.60 per service for a new domestic connection - where there is existing infrastructure, this will be reduced. Even in a low bill area such as Severn Trent, the present value of 12 years' income for the water service would be over 400% higher than the combined infrastructure charges currently paid.

Given the proposed changes to infrastructure charging noted above, how the new approach will work alongside these changes will depend on the balance of onsite costs to new infrastructure charges. Where these are broadly equivalent, the impact will be minimal, where there is a difference the change could be significant both for companies and developers. In our view, this will only make the situation more complex. It will also make it more difficult to show the linkage between infra charges and the 5 year value of network reinforcement expenditure, as we would need to write back the value of discounts provided before making this comparison.

Offset calculation should recognise the cost of on-site infrastructure

The economic substance of transactions relating to the offset calculation is that:

- There is a cost to laying local mains on a new site;
- The incumbent company will derive some future economic benefit from the asset, which is set off against the cost;
- If benefits exceed the cost of laying the mains, the developer does not need to make a contribution; if not, the developer contributes the excess.

Valuing that future benefit as the present value of 12 years' charges is somewhat arbitrary. The calculation is archaic, and we would welcome the opportunity to replace it. However, it is important to remember that it is only a proxy for the future revenue stream arising from the on-site assets.

The infrastructure charge is supposed to cover an entirely different set of costs - for upstream reinforcement. Applying an offset on infrastructure charges would appear to address concerns about double-charging for reinforcement, but as noted above, Ofwat has already addressed the potential for double-charging by making a clear division on reinforcement costs to those on-site.

Asset payments should not be made to new appointees

Whilst it is not clear from the consultation whether Ofwat is proposing that NAVs should receive an offset payment, or whether this is a point raised to invite comments, we do not agree with the idea that asset payments should be made to new appointees (NAVs).

Where we construct mains, we pay for them and own them; where they are laid by an SLO, we pay for them because we will adopt them and derive the economic benefits from ownership. Where the asset is constructed by a NAV, we do not own or have responsibility for maintaining these assets. Therefore we do not think that incumbents should effectively pay for an asset that they do not own.

The table below illustrates this:

Development route	On site construction costs	Economic obligations & benefits	Who pays
Water			
Requisition	Incumbent – up to limit of DAD calculation	Incumbent	Water customers – excess reflected in price of house or other property
Self-lay	SLO	Incumbent (on adoption)	As above
New Appointee	NAV	NAV	As above (paid to NAV)
Sewerage			
Requisition	Developer	Incumbent	Reflected in price of house or other property
Self-lay	Developer	Incumbent (on adoption)	As above
New Appointee	Developer	NAV	As above

However we appreciate the concerns raised by NAVs – we have been working with IWNL on the development of a new NAV specific charge. The key question for NAV charging is whether the future revenue available to the NAV is sufficient to cover the cost of financing and operating the NAV’s on-site network. We think this is best achieved through a discount to primary wholesale charges and have stated that we will introduce a charge for this purpose in 2017/18.

However, if we were obliged to pay for the NAV’s infrastructure, then:

- Any discount would need to be dramatically reduced – the NAV should not receive financing costs for assets that it has not paid for
- Any discount would need to be based on the cost of maintaining the assets alone – likely to be very low in the short-term
- The NAV’s incentives to maintain the assets for the long-term would be reduced (since it would already have received the full value of any investment).

Alternatives to the DAD calculation should not harm competition

The consultation notes that Self-Lay Organisations (SLOs) are concerned about a possible reduction in asset payments that they receive under an alternative method such as a flat percentage. We do not see why this should be the case. Government guidance is that the balance between developer and customer contributions should not change – so any alternative calculation should create similar payments (taken across sites) as the existing DAD approach. Provided the value made available to a SLO is the same as if the incumbent had laid the on-site mains and other infrastructure, we do not see why any competition concerns should arise.

Q4 Do you have comments on our proposed approach to implementing our rules?

The rules changes could have an impact on the publication of wholesale prices in October, due to the combined revenue cap and the impact on wholesale charges to NAVs as noted above.

We note that Ofwat’s proposals give companies scope to make changes in 2017/18, but do not mandate significant movements in the short term. We think that adopting a phased approach is important. While it is true that companies are not required to publish charges to developers in October, the forecast level of capital

income does have an impact on other wholesale charges, as noted in response to Q3. So changes in the charging regime for next year would have an impact on all customers, and could conflict with any charges set in October.

Q5 Do you agree with the approach we have taken to our draft impact assessment? Can you provide quantitative figures in terms of the potential benefits or costs? Is there anything we have missed?

Key Benefits

We agree that the proposals will support the following benefits:

- *Unlocking competition*: The rules will socialise the of 'first mover' disadvantage and so unlock competition
- *Encouraging innovation*: Giving companies flexibility to develop their own charging structures, will enable companies to develop incentives via charging that support better use of resources
- *Environmental benefits*: The use of locational based pricing could help signal to developer's unsustainable abstraction and minimize network reinforcement. However this would require the offset not to be applied against the infrastructure charge.

We do not agree that the following benefits will be achieved from the current proposals:

- *Encouraging transparency and predictability*: The key issue is that benchmarking will be difficult if a high diversity of approach to charging is delivered.
- *Long term reduction in disputes*: Whilst giving companies greater flexibility should help promote more sensible charging, it's also possible that greater variations could prompt more legal actions as developers seek to encourage greater consistency.
- *Wider economic benefits*: Our rules might lead to a positive impact on the whole of society such as speeding up housebuilding which may help to reduce the housing deficit. This statement would only hold if charging rules were acting as a significant inhibitor to housebuilding. We have not seen any evidence to suggest that this is the case.

We are unable to provide quantitative figures for potential benefits or costs at this time.

Q6 Do you have any comments on the drafting of our new connections rules?

Timetable - The requirement to publish charges no later than 2 months before the period in relation to which they affect (in effect the first working day of the February 2017) significantly impacts the time available to identify, select, effectively consult on and implement a 'best in class' option for charging, especially when we are without a confirmed rule set at this time. That is assuming the delivery date of April 2017 is maintained.

Infrastructure charges - We think it is reasonable to make a comparison between the long-term costs of reinforcing networks and the charges received. The choice of a five year period for the comparison is possibly too short. The impact of new connections can occur over a prolonged period of time. We would therefore welcome a longer time period.

Income offset - By not prescribing a method or appropriate timescale for income offsetting we believe there could be significant differences in approach reducing the comparability of charges and increasing the need for dispute resolution. It would be helpful for Ofwat to mandate a time period (which could potentially reduce casework that might otherwise be prompted by differences).

Definition of 'Charging Arrangements' - We think this could do with some clarification. As drafted this means a "a document setting out the charges, Income Offsets and Asset Payments or the methodologies for calculating those, applied by the water or sewerage undertaker in accordance with these rules". The setting out of Charges 'or' the methodology for calculating these charges appears to be contradicted by Rules 9 and 11 which requires in all circumstances would require both.

Rule 14 stipulates that charges must be published in such a way that 'Developers can confidently work out a reasonable estimate of the charges payable if they know the relevant parameters of the Development Site'. Is this all that should be required to be known by a developer? Or are things like location (zonal charging), volume of plots also required?

Rule 16 providing Developers with a 'reasonable choice of methods of payment' makes sense, however clarification on 'reasonable choice of times' would be beneficial.

Rule 19 references to 'present rules' and 'present balance' may cause ambiguity. It would be clearer and more comparable if the required 'balance' was expressly stated as an ongoing obligation, particularly in light of the slightly different interpretation provided in Defra guidance.

Rule 26 - Further 'summary' of Network Reinforcements is not required. The word 'Sewer' is also missing from the final sentence in brackets.

Annex: Information requirements – iii. Same point as Rule 19.

Q7 Do you have comments on the draft changes to the charges scheme rules?

The requirement to publish no later than the first working day of the February preceding the charging year (April) seems reasonable year on year, but imposes significant challenges with respect to April 2017 (the first year of charging).

A single connection to a local distribution network will drive no new investment – it may be the 1,000th connection, occurring after ten years of growth that creates the cumulative need. In this context, the wording of Rule 30 is potentially problematic – it is very likely that charges will relate to pre-existing issues to some extent (although these will have been caused by past requisitions).

Q8 Do you have any comments on the drafting or our proposed licence modification, including the wording of the illustrative example.

In light of the current proposed timescales use of s55 to modify licence conditions is reasonable. In relation to the proposed modification we agree in principle with the illustrative drafting. Further consideration will be required in relation to final drafting in order to accommodate individual IOA's. We would be happy to engage further in that regard.