

# Welsh Government Consultation on supplementary charging guidance to Ofwat

Severn Trent Water response  
16 January 2017

## Summary of our response

Thank you for the opportunity to comment on the Welsh Government's supplementary charging guidance to Ofwat.

Severn Trent is proud to serve our customers in Wales and, if successful in our proposed acquisition of Dee Valley Water, plan to operate the whole of our business in Wales under a single Welsh licence. All of our regulated customer-facing operations in Wales will, therefore, fall wholly under the remit of Welsh Government policy.

We welcome the overall approach being taken by the Welsh Government to charging policy and particularly support:

1. The focus on sustainable development. With the approach set out in the Well-being of Future Generations (Wales) Act, Wales has the opportunity to be a leader in this area and the water sector should be expected to play its part.
2. The promotion of whole catchment approaches to managing water resources. This approach makes sense from an environmental and economic point of view. The presumption in favour of sustainable solutions set out in the draft guidance is particularly welcome.
3. The emphasis on transparent and predictable charges for developers, balancing the costs that they bear against the impact on other customers.
4. The importance attached to supporting vulnerable customers.

We think that customer protection should be at the heart of charging policy. Effective social tariffs need to be combined with a general drive to keep bills affordable (for this and future generations of bill payers). Investment plans should be shaped by customers' priorities and that service performance is measured effectively.

Markets in the limited but important areas of water resources and sludge processing could achieve better environmental and economic outcomes for customers. They could reveal the full and fair cost of water trades and potentially improve resilience, which is a key objective of the Welsh Government.

We agree that bulk supplies should not be subsidised in any way (as set out in section 5.3 of the draft guidance). Designed correctly, a market for water resources could help achieve the most environmentally efficient allocation of resources.

While the guidance should set out clear policy objectives for Ofwat, it could also emphasise the Welsh Government's commitment to independent regulation. Investor confidence in the political independence of the regulator is a key factor in ensuring cost-effective investment into the sector. It is important that commercial agreements between two organisations have recourse to independent regulatory oversight. Any action that increases perceived political or regulatory risk in Wales could, in the long run, be damaging for the Welsh economy as a whole, not just for the water sector.

We would welcome the opportunity to meet with you to discuss further.

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## Response to consultation questions

*Q1: Please provide your views on the proposed guidance to Ofwat on developer charges set out in section 4.*

We agree with the emphasis on transparent and predictable charges. The consultation recognises that in practice there may be trade-offs between the proposed principles—for example, between simplicity and cost reflectivity. Providing a menu of standard services with a simple price structure - such as a cost per dwelling – is a reasonable objective.

The more items that are included in the menu, the more complex it will become. For example, if there are different prices for single and multiple build applications (4.14) this will improve the cost-reflectivity of the charges. However, this is not the only factor that might affect costs and if each adjustment was included the menu could rapidly become a complicated matrix.

Our preference would be for a simple menu for standard services. This will require the company to define that standard and the circumstances under which additional charges would apply (the exceptional costs discussed in 4.13). It is important that these costs should not be borne by all developers through an averaged charge, and the charging structure sends appropriate price signals. This is not simply discouraging development that would impose unreasonable cost; companies should be able to put forward positive schemes that encourage sustainable development. We are proposing a trial of such discounts in April 2017.

*Q2: Do you think that each of the principles set out in paragraph 4.4 should be given equal weight in setting charges, or do you agree that transparency, predictability and timeliness should be given a higher weight in decisions about charging rules?*

It is possible to give equal weighting to each of these principles, if cost-reflectivity is considered at a high level. Charges based on average costs would be simple, transparent and could fairly reflect the total cost of connecting new developments. These principles are only in conflict if costs are considered at the level of each individual site.

Most water charges are based on regional averages rather than the specific cost of serving a particular property. We think a simple, transparent approach based on average costs is reasonable—allowing for the specific costs in atypical cases such as described in 4.13.

*Q3: Do you agree that all developer charges, including requisition charges and infrastructure charges, and associated charging rules should reflect the objectives and principles set out in this guidance? Should requisition charges and infrastructure charges be incorporated into the simpler charging structures that are referenced in Chapter 4?*

The principles set out in this guidance are equally relevant to on-site charges, requisition charges and infrastructure charges.

*Q4: Do you think that the approach of requiring a default tariff and the flexibility to offer alternative tariffs (paragraph 4.8) is appropriate?*

As set out in response to the previous questions, we support the introduction of simple, transparent charging structures which give developers greater certainty in order to plan their activity.

Unless the range of charges within the default menu is very extensive (undermining the objective of simplicity), it will not cover all circumstances. Therefore, we think it is important for companies to have some flexibility to offer other charge options. This will enable companies to send proper price signals, for example to encourage sustainable development. An approach that is too rigid could also lead to unintended consequences which the company would then be unable to address.

We do not see this flexibility as offering a choice of charging approaches in all circumstances; this would simply lead to developers (or companies) choosing the charge that is most advantageous for the site in question. Under normal circumstances, the standard or default charges ought to apply.

*Q5: Please provide your views on the proposed default tariff.*

We agree that there should be standard prices such as a cost per dwelling and consider that a rolling five year average comparison to costs is reasonable. While we would support this being *presented* as a charge that covers both on and off-site costs, we think that – if this approach is adopted - the split behind the “headline rate” must be preserved.

Firstly, off-site costs should be funded through the infrastructure charge (an average costing approach). This is in line with Ofwat’s latest proposals. Prior to this, a number of companies had different approaches with some charging developers for deep reinforcement and some not, leading to confusion. Now that Ofwat has clarified the distinction between the funding of shallow and deep connection costs, it is important this is not reintroduced.

Secondly, on-site connection services are open to competition from Self Lay Organisations and New Appointees. When they provide the connections on site, the developer will still have to pay infrastructure charges to the incumbent, so in the interest of transparency it is important that this is clear to developers.

*Q6: Paragraph 4.14 raises a number of issues that Ofwat needs to consider in setting charging rules for developer charges.*

*a. Do you think Welsh Government should give further guidance to Ofwat on each of these points? If so, what should that guidance be?*

Further guidance could be required if Ofwat’s Charging Rules might otherwise be incompatible with statute in Wales - for example, to ensure that the requirements for sewer adoption are met.

*b. Are there other issues that should be included in this list of issues?*

No Comment.

*Q7: Please provide your views on whether it would be helpful for Ofwat to introduce a charging scheme for bulk supply and/or bulk discharge.*

It is important to recognise that there are two main circumstances in which bulk supplies can be made:

- Supplies between incumbent water companies, many of which are covered by historic agreements.
- Supplies to New Appointees and Variations (NAVs) which serve areas within or adjoining an incumbent's area of appointment.

When considering the charging principles and rules that might apply, these are different cases. For the former, approaches vary. For small volume, generic bulk supplies where there is no specific agreement in place we currently charge at the standard wholesale rate. However, larger transfers tend to be subject to agreements which take account of the specific costs involved, for example:

- whether the water is potable or a transfer of raw water;
- the use of shared assets; and
- the recovery of investment made specifically in order to facilitate the supply.

The charges tend to be based on localised costs and this may not lend itself to a set of overarching rules set at a national level. In Ofwat's emerging proposals, any entrant bidding in to an incumbent's Water Resource Management Plan would need to base their proposals on the specific costs of the supply. To be successful, they will need to cost less than the incumbent's incremental cost for new resources – not the incumbent's average costs or even its average costs for the Water Resource Zone to which the supply will be made.

These new water trades may be more like the agreements that are already in place for large bulk supplies between wholesalers and less like generic average charges. Therefore if any charging guidance or rules is issued they will need to be set at the level of high principle and should avoid undermining commercial agreements that have been made in good faith.

On the other hand, with the second type of bulk supply a simpler approach is possible (as we have implemented in our new Scheme of Charges for 2017/18). In this case, the considerations are wholly different, the key aim being to ensure a level playing field between NAVs, incumbents and Self-Lay Organisations. Our NAV charge is a bulk supply which aims to provide a discount that sufficient to cover the cost of financing and maintaining an average local network (the local assets which will be owned and operated by the NAV).

*Q8: Please provide your views on the proposed guidance to Ofwat on bulk supply charges set out in section 5.*

We agree that bulk supplies should reflect the costs involved (as set out in section 5.3 of the draft guidance). Designed correctly, a market could improve overall efficiency, if the full environmental costs of water trading is properly taken into account. But we agree that companies should not be encouraged to pursue bulk supplies outside their area of appointment to the detriment of either their existing customers or to the environment.

It is reasonable for Ofwat to consider the cost principles that should be applied to new water trades. But where existing bulk supplies are in place, and the two parties have entered into an agreement in good faith, new rules and methods should not apply retrospectively.

Existing supplies will already have been taken into account within Water Resource Management Plans of both the supplier and the recipient. It is therefore unlikely that there is a detriment to the supplier's existing customer base (5.3). The application of new rules could, however, jeopardise services to the recipient of the supply.

Where bulk supplies pre-date privatisation, we think the prices paid should already reflect the correct cost of provision:

- The assets involved were already constructed.
- Investors valued those assets (and the business as a whole) on the basis of the cashflows that each company could expect to receive.
- This valuation was locked into companies' initial Regulatory Capital Values.
- Any investment that each company has made to maintain or improve the assets since privatisation has been remunerated through the price control.

If the terms of an existing supply are changed and the receiving company has no viable alternative, this simply transfers value from one company to another. Ultimately this means a transfer from one group of customers to another since the extra costs and savings will simply be passed on to bill payers.

It is important that commercial agreements between two organisations have recourse to independent regulatory oversight. Any action that increases perceived political or regulatory risk in Wales could, in the long run, be damaging for the Welsh economy as a whole, not just for the water sector.

*Q9: Please provide your views on the proposed guidance to Ofwat on bulk discharge charges set out in section 5.*

Our views in respect of the guidance on bulk discharges are identical to those for bulk supplies, although in practice the number and significance of such agreements is lower.

*Q10: Please provide your views on the proposed guidance to Ofwat on access charge rules set out in section 6.*

The principles underlying the guidance on access prices are sound. Since the only access pricing arrangements that are currently in place are for retail access made under the Water Supply Licensing regime that was established prior to the opening of the new market, we think that it is reasonable for Ofwat to consider whether transitional arrangements are necessary; this raises none of the concerns we have with regard to bulk supplies.