

Consultation on connections charging rules for Welsh companies

Hafren Dyfrdwy response

February 2021

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Summary of response

In broad terms, we would support some alignment between the charging rules in England and Wales. We believe there would be advantages to stakeholders within the market if there were fewer differences in rules for customers to understand, since many developers undertake work on both sides of the border.

We support the up-front publication of charges wherever this is practicable, and we intend to apply a site-specific approach to charging in our area. We strongly support the view that off-site reinforcements should be covered by the infrastructure charge rather than by individual developers. And, on balance, we believe that it would be better to align the approach on the “income offset” with England to avoid confusion for developers who currently must deal with different systems on each side of the border.

Although we intend to adopt many elements of “option 2” in our approach to charging, irrespective of whether these are required in the charging rules, we support the more flexible proposals of “option 3”. In particular, we think that some of the more prescriptive requirements for consultation and publication would be disproportionate to a company of our size.

As highlighted in our previous response, we do not think that infrastructure charges based on average reinforcement expenditure over a 5-year period would be appropriate for Hafren Dyfrdwy. This approach would lead to charges of zero in periods when no reinforcement was taking place and would impose excessive charges in future when the cumulative effects of growth need to be addressed; significantly impacting the stability and predictability of customers charges.

We acknowledge that Ofwat has gone some way to address the issue of scale by proposing a 10-year period, but we do not think this will be sufficient given the difference in scale between HD and the rest of the industry. Hafren’s water service is less than one third the size of the next smallest company (Portsmouth), while our wastewater service is just 5% of the size. Our water service completed 288 connections last year, the wastewater service just 66 (residential and business).

We would suggest that an alternative approach to infrastructure charges should be adopted for HD. We support the principle of cost-reflectivity, but these costs cannot be averaged over any realistic time frame with a service this small. This is why, as set out in our previous response, we would favour a relative control for infrastructure charges whereby HD’s infrastructure charges were pegged to neighbouring companies or to the industry average. Relative controls are already used for new appointees, some of which are larger than HD’s wastewater service.

Brief answers to the specific questions raised in the request are included below.

Kind regards

Shane Anderson
Director of Regulation and Strategy

Response to detailed questions

1. Do you agree with our proposal to redefine what costs are recovered by infrastructure and requisition charges?

As we set out in our response to the previous call for information, our view is that the main concern with the existing framework in Wales (and the old regime in England) related to reinforcement costs. Across the industry companies adopted different approaches, with some including an element of these costs as part of the requisition charge. Understandably, this gave rise to a concern that developers were being charged twice, as the infrastructure charge also applied.

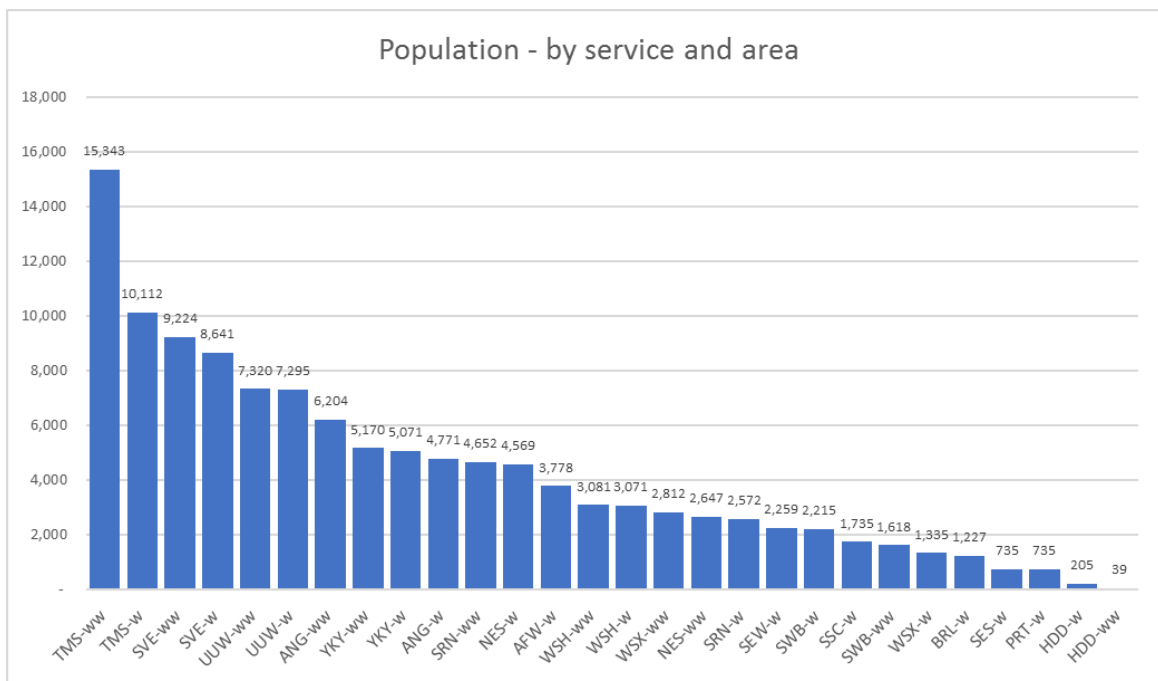
Clarifying that reinforcement costs should be covered by infrastructure charges resolves many of the potential disputes between developers and water companies. Aligning with the approach now adopted in England may also improve the customer experience, since developers will not have to deal with different systems on each side of the border.

2. Do you agree with our proposal that infrastructure charges should be calculated to recover costs incurred over a rolling period of years? and

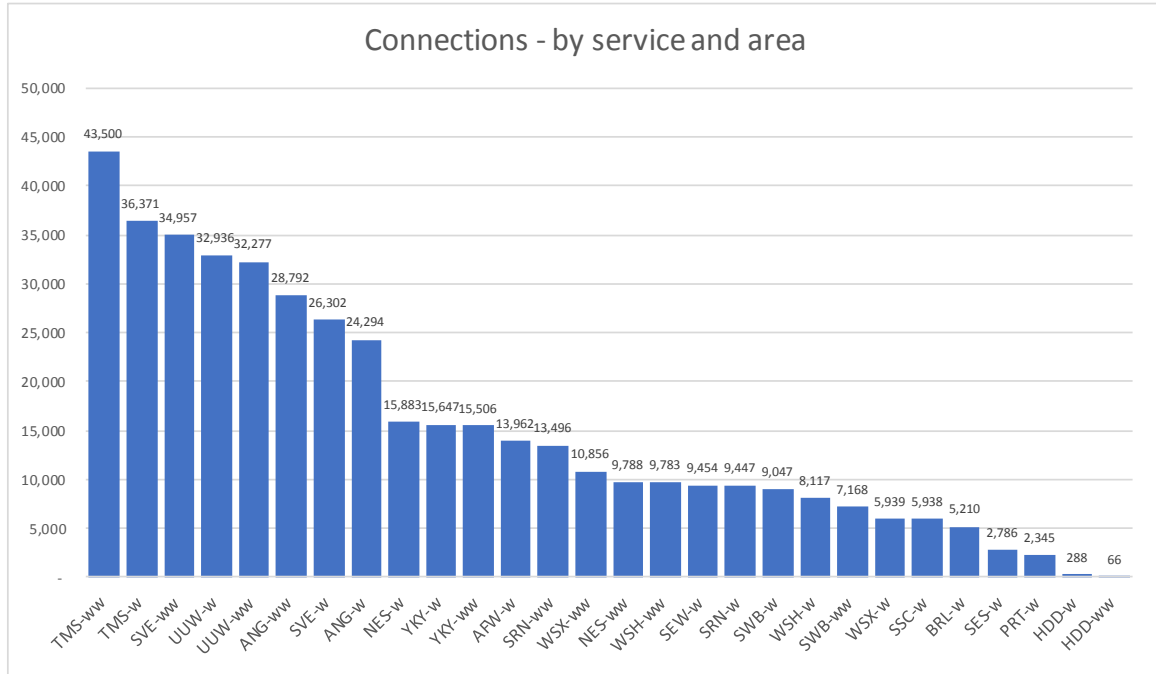
3. Do you prefer option 2 or option 3 (or another approach) as the basis for setting the relevant time period over which costs are calculated for the purpose of setting infrastructure charges?

We appreciate that Ofwat has engaged with us regarding the rolling period for infrastructure charges. The option of using a 10-year period would clearly be an improvement over a 5-year approach and we acknowledge that Ofwat is tailoring its overall approach to fit the unusual circumstances of Hafren Dyfrdwy. However, we do not think that a doubling of the period will be sufficient to address the scale issues with the averaging approach, particularly for our wastewater service.

Hafren Dyfrdwy’s water service is less than one third the size of the next smallest company. Our wastewater service is less than a fifth the size of our water service, making it around 5% the size of the next smallest company that is subject to full regulation (Portsmouth Water).



HD carried out 288 connections (residential and business) for water last year and only 66 for wastewater. The level of developer activity last year was low even relative to the company’s size, which may reflect the rurality of the area we serve: wastewater connections were around 2.8% of the next lowest company (Portsmouth).



We have considered the implications that averaging reinforcement costs through charges could have when volumes are this low. While our water service is very small in comparison to other companies, we focus on the wastewater service, which is an order of magnitude smaller than the next company.

In AMP6, Severn Trent undertook a significant wastewater reinforcement project at Newark (this was during the period when HD waste was part of SVT). Newark has a population of around 28,000, which is comparable to the area of Powys that we serve. The project cost £65m of which £4.3m was classified as reinforcement. If the developers connecting in the Newark area alone had been required to pay these costs – even over ten years – then they would have faced an absurd charge. For example, with 66 connections per year a £4.3m reinforcement project in Powys would require infrastructure charges of c£6,500 per connection, even if spread over 10 years. Since Condition C still applies to HD the current charge is £402.15.

The requirement for investment was the result of decades of growth in Newark, not the development over a short period of time. If we had operated an infrastructure charge based on 5-years’ expenditure in such a small area, all developers connecting before AMP6 would have been “free riders”, contributing to the need but not the cost. Now that there is capacity, all developers connecting there for several decades would also pay infrastructure charges of zero. Within larger companies, the averaging approach will work out reasonably well because there will be a need for reinforcement *somewhere* within the region and all developers will be contributing to that requirement. In a small area, the approach breaks down.

As we noted in our earlier response, if HD’s wastewater service was a stand-alone business it would fall below the threshold for small company reporting. Our water service is also much smaller than any other company that is subject to full regulation. We do acknowledge that Ofwat is trying to adapt this approach

for HD, but we think that a one-size-fits all methodology may not be appropriate for a company of HD's size. No reinforcement is planned for HD's wastewater service during AMP7.

If a 5-year average is considered appropriate for a company the size of Portsmouth (and we are not sure that it is), then HD water reinforcement costs should be assessed over 15-20 years to derive an appropriate average, while wastewater would need to be assessed over 100 years. Since this is impractical, we would propose a relative control whereby infrastructure charges are pegged to costs in a larger area – either our neighbouring companies (which should reflect regional costs to some extent) or the average in England and Wales.

There is precedent for relative pricing, which is used for New Appointments and Variations. We acknowledge that this would involve HD's infrastructure charges being set by reference the costs of other companies but – as we have set out in the example above – the charge in Newark is not set by reference to the costs in Newark. The reality is that these costs arise over a much longer period than 5 years, but averaging costs over a larger area can compensate for this limitation.

4. Do you agree with our proposal to simplify the calculation of income offset and apply it to the infrastructure charge, instead of the requisition charge (thereby removing the need for asset payments)?

We support this proposal. There are some disadvantages to the way that the "income offset" is now set off against infrastructure charges rather than requisitions in England. It operates to the disadvantage of developments that requisition a main; at present we lay these for free in most developments where they are required, and developers only need to make a contribution when costs are particularly high. There is also a cashflow impact for the developers that requisition a main, as the "income offset" will be received later than in the previous approach. This is also the position for Self-Lay Providers, where HD will currently make an asset payment when mains are constructed rather than when properties are connected.

We think these problems are outweighed by the benefits of a harmonised approach for developer customers. There are also advantages to smaller developers, who will receive a contribution. There has been a great deal of change for developers within a short period of time, especially when compared with the period from privatisation to the end of AMP5. On balance, we think that customer experience for our developer customers would be better if there were fewer differences in regulation between England and Wales.

5. Do you think option 2 or option 3 is the better approach to setting upfront charges for site-specific developer services? Or would you prefer another approach?

We will set up-front site-specific costs so far as practicable. As the consultation notes, it would still be possible to do this under option 3 and the latter recognises the difficulties we may face in costing all services when we have provided very few jobs to use as a basis for fixing expected costs.

6. Do you think option 2 or option 3 is the better approach to setting charges for requisitions and new connections? Or would you prefer another approach?

Our approach is to reflect the specific costs of the site in requisition charges, consistent with option 2. However, we note that option 3 does not preclude this approach; it simply allows companies to reflect costs in general if they wish to do so. We also note that Dŵr Cymru is considering a charge per plot approach and we think that it is important that companies are permitted to trial alternative approaches to charging if these are supported by their customers.

7. Are there any charging rules that have been included under options 2 or 3 that are not required due to the general requirements of the charging principles?

The rules under the two options are all relevant. As we have set out in our response to questions 2 and 3, we do not consider that the method for calculating infrastructure charges (rule 28) is appropriate to a company of Hafren Dyfrdwy's size.

In Box 5.1, Ofwat suggests that where this approach gave rise to a significant increase in the infrastructure charge, companies should consider increasing the income offset to ensure that the current balance is maintained. We are not sure this would maintain the balance between regular customers and developers. We believe the income offset should be equivalent to the amount that companies would have paid towards requisitioned mains. This does not appear to be consistent with an increase that is designed to mitigate changes in the methodology for infrastructure charges.

We note that although this suggestion is made in Box 5.1, there is no reference to this within the draft charging rules. We think it would be difficult to frame a rule that would cover this point. Volatile infrastructure charges – with regular water and wastewater customers contributing more when charges rise – will not maintain the balance that currently exists.

8. Are there any additional charging rules that should be included under options 2 or 3?

We have not considered any additional rules that ought to be applied.

9. What are your views on the three proposed options? Which of the options do you prefer? Would you prefer another approach?

As we have set out above, we support a move to charging in greater alignment with England, because fewer complications for developers that operate on both sides of the border should improve the customer experience. Given the size of Hafren Dyfrdwy and the number of connections that we undertake, we broadly support option 3 and this is our preference.

We do not feel that the summary of differences between options 2 and 3 (table 5.1) reflects all the key differences between the options. We summarise our views below.

- **Upfront fixed charges:** our approach would be to publish these so far as practical. But, given the practicalities of doing so based upon low volumes, we support the flexibility of option 3.
- **Site-specific:** our approach would again be consistent with option 2, but we support the flexibility for Dŵr Cymru to trial an alternative approach as in option 3.
- **Customer consultation:** while we agree on the value of customer engagement, we are not sure about the practicality of implementing this for HD given the small volumes involved. We would therefore support option 3.
- **Publication of charges:** While we would aim to publish as many of the charges as possible up-front, publishing the worked examples for varying sizes of development would involve a high level of extrapolation – in some instances we will not have any examples to draw upon based on our workload in any given year. On this basis, we support option 3.
- **Off-site costs and enhancement:** This is not mentioned in table 5.1 but is a key difference between options 2 and 3 as drafted in the Appendix 2 Rules. We fully support the restriction that charges to developers should not be used to address pre-existing deficiencies and that reinforcements to the upstream network should be covered by the infrastructure charge.
- **Overall:** It is worth noting that how well companies proactively engage with their customers to set their charges and deliver value for money will be reflected in D-MeX. It is already in a company's best interests to provide simple charging frameworks that aid customers with their desire for fair, predictable and transparent charging that enables cost certainty.

10. Are there any other issues we should consider as part of our assessment of the impacts of introducing the proposed charging rules?

We think that the impact assessment covers the right areas, but the difference in effect between options 2 and 3 has been underestimated. The consultation considers that the implementation costs from moving to the new framework would be relatively minor due to the fact that there has been extensive consultation and therefore the companies will be fairly familiar with the requirements already. However, this does not consider the continuing cost of compliance with the more detailed requirements of option 2.

Under option 2, we would have a requirement for meaningful consultation with our customers before charges come into effect, and to publish worked examples of charges for typical development sites. Our charges must be cost-reflective, meaning that the costs associated with any consultation must be borne by our developer customers. Again, we must draw Ofwat's attention to the size of Hafren Dyfrdwy (see question 2 and 3) and ask whether this level of regulation is proportionate.

Conducting any kind of consultation has a cost. Larger companies will organise workshops, forums, issue consultations and perhaps engage market researchers to gauge customer views. Although HD has few connections, any developer operating in the rest of the country might choose to build on a site in the area, so our engagement could not be limited to those that are currently active in our area of appointment. Given our size, we would have to choose a more low-key approach; even so this would make a material impact on our developer charges. With connections of around 300 per year (both services), even if the exercise cost £1,000 (and it would be more than this in reality) we would be asking our developers to pay for overheads of £3-4 per connection in order to ask them what they think about their charges.