

COMPLIANCE WITH COMPETITION LAW AND CHARGING RULES OBLIGATIONS WITH RESPECT TO THE SELF-LAY MARKET FOR NEW CONNECTIONS – 2019/20 CHARGES

1. INTRODUCTION

On 29 April 2019, Ofwat wrote to water companies regarding receiving a number of complaints over the last 12 months in which it has been alleged that incumbent water companies, through their charges, contractual terms and/or actions, have made it difficult for self-lay providers (SLPs) to compete and operate efficiently in the developer services markets.

In the note below, we set out U UW’s assessment of its approach against the criteria described by Ofwat.

2. RESPONSE TO POINTS RAISED

<p>Compliance with competition law and charging rules obligations with respect to the self-lay market for new connections</p>
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<p><i>It is not clear as to what services are included in the design fees and other developer service charges or how the charges for these services are calculated or compare between requisitioned and self-lay provision.</i></p>

Most of the charges applicable are fixed charges. Each of these fixed charges has been built up to reflect the costs associated with providing each service. The costs included in each charge are noted in the charges scheme.

For example, in section 6.3.1 the self-lay application fee (design by SLP) states that the charge includes “processing of application, creation of legal agreement, design approval, confirmation of the fixed price and initial site inspection”.

Those charges which are not fixed have a methodology to explain how the cost will be derived.

Charges which are not fixed largely relate to exceptional circumstances. Examples of these are covered in section 16 of the new connections and developer services charges scheme. In this section items to be included in the build-up of the cost are outlined to provide an indication of the types of costs that would be included when the charge will be calculated.

<p><i>Many companies have failed to transparently demonstrate to us and customers how their charging schemes satisfy paragraph 21 of our charging rules for new connections which requires that “Charges (including any Income Offsets), any Asset Payments and arrangements for when they are each payable must be set in accordance with the principle that they should promote effective competition for Contestable Work”. We have set out more detail of some of our concerns arising from the recent complaints in the annex to this letter to illustrate the types of matters companies should be considering further.</i></p>

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Most of our published charges are fixed charges. Each of these fixed charges has been built up to reflect the costs associated with providing each service.

We believe that the charges have been set at an appropriate level to allow companies to compete in downstream contestable markets. This is demonstrated through the high level of SLP activity in the UUW area.

For example the calculation of the asset payment is completed on an equivalent basis to the income offset and applies to developers, self-lay providers and NAVs (for a NAV this is provided as part of their new bulk supply agreement).

The charging rules and companies' competition law obligations require companies to ensure they are fully considering the effects of their charges and charging scheme documents on effective competition.

We have considered the effects of our charges and charges scheme documents on effective competition.

We believe that the charges have been set at an appropriate level to allow companies to compete in downstream contestable markets.

Given that SLPs undertake the majority of contestable work in our appointed area we consider that this demonstrates that our charges facilitate effective competition.

The assurance statements companies are required to submit to us are intended to confirm they consider that they are complying with the charging rules and their legal obligations. It is imperative, therefore, that all water companies take action to ensure that their practices in these areas are consistent with their competition law and other regulatory obligations.

Our charges scheme assurance statement states that the new connections and developer services charges scheme is prepared in accordance with legal obligations.

We believe our practices in these areas are consistent with competition law and other regulatory obligations.

We believe we have taken the appropriate steps to ensure compliance with competition law.

Companies should be taking appropriate steps to ensure that charges are cost reflective and that their approach to setting any charge or income offset is transparent and does not result in a situation where an equally efficient competitor is unable to compete with it on a level playing field.

Our published charges have been built up to reflect the costs associated with providing each service. Where charges are largely based on contractor costs these have been subject to a commercially tendered process.

We believe that the charges set are cost reflective and have been set at an appropriate level to allow companies to compete on a level playing field.

In addition, the calculation of the asset payment is completed on an equivalent basis to the income offset and applies to developers, self-lay providers and NAVs (for a NAV this is provided as part of their new bulk supply agreement).

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If water companies are effectively consulting on their proposed new connection charging arrangements with customers and stakeholders, they should be able to identify and comment on any potential issues before the charging arrangements come into effect.

We have consulted with stakeholders during the development of the charges for 2018/19 and 2019/20 to ensure they are customer focussed and transparent.

For example a simple discounted infrastructure charge for water and wastewater was introduced in 2018/19 based on stakeholder consultation (stakeholders have been clear in their feedback that they want simplicity and cost certainty) and recommendations from the Water UK consultation. This discount has been maintained for 2019/20.

We continue to consult with stakeholders on a regular basis and act on feedback as appropriate. We publish our stakeholder engagement activities alongside our charges assurance statement on our website. We also publish the feedback received and our resulting actions.¹

Inconsistent application of methodology to calculating Asset Payment and Income Offset

We have identified that some water companies are disadvantaging self-lay providers when calculating asset payments and income offsets. This is particularly the case where income offsets are set to be a percentage of requisition costs.

For new mains laying schemes from 2019/20 the income offset/asset payment is calculated on a per plot equivalent basis for both household (HH) and non household (NHH).

We believe our approach does not disadvantage SLPs.

The calculation of the asset payment is completed on an equivalent basis to the income offset (section 6.6 of the new connections and developer services charges scheme).

Section 17 of the new connection charges scheme (Appendix – example developments) demonstrates that the income offset/asset payment is applied on an equivalent basis in the statutory mains requisition example (17.2 page 63) and the Self-lay mains example (17.3 page 65)

(Note: we removed the 68% fixed percentage that applied to NHH/Mixed use sites for new schemes in 2018/19 following stakeholder feedback indicating a preference for a fixed per plot value for both HH and NHH developments).

In some areas, water companies have identified that when requisitioning new connections the excavation and subsequent reinstatement work for new connections is often carried out by the developer itself, resulting in the company's requisition charge being calculated on the basis of lay-only costs. Because of this some companies are choosing to exclude excavation costs when calculating the asset payment for self-lay provision, i.e. calculating it on the basis of a percentage of lay-only requisition costs rather than the full costs of providing the works that will be adopted.

¹ https://www.unitedutilities.com/globalassets/documents/pdf/acc19.engagement-with-stakeholders-final-2019_20.acc19.pdf

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We can confirm that when calculating the asset payment for self-lay provision this is done on the basis of the full costs of providing the works that will be adopted. We do not exclude excavation costs when calculating the asset payment for self-lay provision.

The calculation of the asset payment is completed on an equivalent basis to the income offset as demonstrated in section 17 of the new connection charges schemes (Appendix – example developments).

Where the water company undertakes the excavation works, it only charges a percentage of these costs to the developer, with the rest being paid for by existing customers through the income offset. Whereas if an SLP undertakes the excavation and reinstatement (either directly or via by its own commercial agreement with its developer customer), we have found instances where it does not receive an asset payment for this part of the work. This does not create a level playing field for self-lay providers to compete.

The calculation of the asset payment is completed on an equivalent basis to the income offset. We believe our approach satisfies the requirement to create a level playing field for self-lay providers to compete.

We are not suggesting that water companies should start charging for excavation and reinstatement services where they do not carry out this work. However, while they continue to offer asset payments and income offset, the Charging Rules require that water companies ensure that they apply a fair and consistent methodology that does not discriminate between whether the developer chooses the requisition or self-lay option.

The calculation of the asset payment is completed on an equivalent basis to the income offset. We believe that this fair and consistent methodology does not discriminate between whether the developer chooses the requisition or self-lay option.

We therefore expect water companies to ensure that the costs they include in the calculation of their income offsets and asset payment are fair and non-discriminatory.

As the calculation of the asset payment is completed on an equivalent basis to the income offset we believe that the costs included are fair and non-discriminatory.

Lack of clarity around charges and when they apply

Water companies typically split the costs of providing design services across a number of different charges including administering the design, vetting the design, checking the design, as well as the charge for the actual design itself. Absent worked examples, it is not always clear which charges apply in circumstances where a self-lay provider supplies its own design, as compared to when it purchases a design from the water company.

Our new connection charges scheme clearly states which charges apply in circumstances where a self-lay provider supplies its own design, as compared to when it purchases a design from the water company.

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For 2019/20 UuW has removed the design service offering for SLPs. The service (and respective charge) has been removed following low take up volumes and stakeholder feedback.

For 2019/20, provision of initial design approval services are recovered through a single charge.

Where a SLP undertakes the design itself (or uses the services of a design partner) there is an application fee of £206 (plus VAT) as detailed in section 6.3.1 (page 15) of the charges scheme. The fee covers the costs associated with design approval (including a series of technical checks comparable to those that would be required for a statutory scheme and any rework required as a result of the technical requirements not being met) and relevant administration costs (including processing the application and creation of the legal agreement).

Where a SLP asks us to revise a quotation for a development, a re-quotation fee is payable (section 6.3.1 Self-lay re-quotation fee £93.00).

This lack of transparency makes it difficult for self-lay providers to accurately estimate the charges they will face and therefore enable them to identify which is the most cost-effective option for them.

The lack of transparency can also arise when water companies seek to recover the costs of contestable and non-contestable work through a single charge, particularly where it is unclear as to the size of the non-contestable element. The costs of requisitioning a water main and making a connection should be recovered through two separate and clearly identifiable charges to ensure that developers and self-lay providers can estimate the charges they will face.

We believe our new connection charges scheme is clear on charges that apply to self-lay providers.

Section 6.3 of the new connections and developer services charges scheme details the charges associated with self-lay schemes, including a cross reference to appropriate construction charges in section 6.5.

Individual contestable and non-contestable activities are outlined within the scheme with the appropriate charge for the service being provided.

Contestable and non-contestable works are charged for separately.

For example the costs of requisitioning a water main and making a mains connection are recovered through separate and clearly identifiable charges detailed in section 6.5 of the scheme.

This allows developers and self-lay providers to estimate the charges payable.

In addition and to further assist self-lay providers to accurately estimate the charges and income offset/asset payment, we have published a self-lay calculation tool on our website.²

The Charging Rules require that water companies publish their charges with sufficient additional information or explanation to make clear what services are covered by each charge, such that a developer or other customer is able to confidently work out a reasonable estimate of the charges they will face if they know the relevant parameters of a development.

We therefore expect water companies to provide sufficient explanation with their charges, including

² <https://www.unitedutilities.com/builders-developers/charges-for-new-connections-and-developer-services-2019-2020>

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worked examples, to ensure that they are clear and transparent, and that developers and self-lay providers are able to identify the costs they will face in typical scenarios.

The charges scheme contains a comprehensive schedule of charges and includes the services associated with each charge. This provides customers with a robust, cost reflective set of charges that can be used to reasonably estimate the provision of site specific infrastructure associated with their development.

In developing the charges scheme consideration has been given to the wording and presentation of the charging arrangements to take into account the varying levels of expertise of all Developers or other customers who may rely on the Charging Arrangements.

A high level methodology is included for those charges at cost.

Most of the charges are fixed in nature. Application and processing fees are clearly listed.

In relation to water developments there are different fixed rates for construction costs to reflect the range of pipe diameters (applicable to requisitions and diversions). Fixed charges have been set for section 45 WIA connections with different rates to reflect the size of connection required.

In relation to sewers a table of indicative rates are provided (section 14). Inclusion of the worked examples in section 17 of the charges scheme will aid users of the charges scheme in calculating the charges payable.

In addition, examples have been included to demonstrate how the different elements add together.

As part of our ongoing stakeholder activity, we share the Charges Scheme directly with a number of stakeholders – CCWater, the Home Builders Federation and Fair Water Connections - to check it is written in a clear manner. We consider all the feedback provided by these stakeholders, alongside feedback from our wider stakeholder consultation activities as part of the review in relation to proposed changes, transparency of charges and other issues raised about our Charges Schemes.

Lack of cost reflectiveness

The charges for providing design services vary significantly across water companies. Some companies appear to be providing their design services for free in certain circumstances, whereas others are charging over £1,000 for what appears to be an equivalent service.

For 2019/20 following stakeholder feedback and low take-up volumes we removed the provision of the self-lay design services (“self-lay mains design fee” and “self-lay application fee (design by us)”).

Under the Charging Rules, charges should reflect the costs of providing the service in question. Although there may be some regional variation in the level of costs incurred when providing design services, we consider that the range of charges that we have identified is too large to explain this.

We therefore expect water companies to review their charges for design services and other contestable services to ensure that they accurately reflect the costs of the activities undertaken in providing the service and that only those activities are included that are genuinely necessary to provide the service. Where we identify that a company’s charges are significantly different from

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those charged by other water companies, we may seek further information to ensure that those charges can be justified.

New connection charges are set to reflect the costs of providing the services, as documented in the charges scheme and the published charges scheme compliance document.

The published fixed charges have been built up to reflect the costs associated with providing each service. The costs included in each charge are noted in the charges scheme.

As part of our annual review of charges we will continue to review the charges for design services and other contestable services to ensure that they accurately reflect the costs of the activities undertaken.

Absence of sufficient margin

Our assessment of the charges faced by developers and self-lay providers for design services suggests that in some cases there may be insufficient margin to enable self-lay providers to compete effectively with water companies in the provision of design services.

In these cases, when the design checking and other charges that water companies impose on self-lay providers are deducted from what the water companies would charge to provide the design, the amount of margin left to cover the self-lay provider's own costs of design work is often less than the amount the water company charges to provide this service (and in some cases is zero). This suggests that a self-lay provider that is as equally efficient as the water company would not be able to compete to provide these services.

For 2019/20 charges U UW has removed the design service offering for SLPs. The service (and respective charge) has been removed following low take up volumes and stakeholder feedback.

We do not believe our activities are limiting competition in the U UW area.

For example in 2017/18 U UW received 502 design applications for new developments, of which 336 were delivered by SLPs.

It further appears that there may be similar concerns in relation to the margins available for self-lay providers when competing against the requisition charges of water companies to provide new connections, though we would need to obtain further information in order to form a more definitive view on this.

SLP activity is far greater than in other regions with SLP's already undertaking the majority (around two thirds) of contestable on-site connection work (mains laying and associated connections).

On this basis we believe that the charges that we set allow sufficient margin for equally efficient companies to compete in downstream contestable markets.

Under competition law, dominant providers have a special responsibility to ensure that their conduct does not distort competition. This includes ensuring that their pricing ensures that there is sufficient margin between upstream charges and downstream prices to enable equally efficient competitors to compete in the provision of services that are based on the upstream inputs provided by the dominant company. The Charging Rules also require that charges be set in accordance with

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the principle that they should promote effective competition for Contestable Work.

Given that SLPs undertake the majority of contestable work in our appointed area we believe that the charges we set are in accordance with the principle that they promote effective competition for Contestable Work.

Consistent principles and approaches have been applied to both water and wastewater new connection charges.

Non-contestable works are calculated on a consistent basis. Standard published charges for non-contestable works apply to all customers. These standard published charges are based on the work being performed.

There is no differentiation in charges between a small, medium or large developer, or self-lay providers. Standard published charges are based on the work being performed.

Water companies should therefore review their design prices to ensure that when their administration, vetting and other design costs are deducted, there would be sufficient margin for a self-lay provider to provide its own design.

For 2019/20 charges UUW has removed the design service offering for SLPs. The service (and respective charge) has been removed following low take up volumes and stakeholder feedback.

We believe the charge for the initial design approval for a SLP (which is applied through the self-lay application fee charge, section 6.3.1) is set at an appropriate level.

As part of our annual review of charges we will continue to review the charges for design services and other contestable services to ensure that they accurately reflect the costs of the activities undertaken.

11 July 2019