

Guidance on financial arrangements for self-lay and requisitioning agreements

Version 1.0

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Guidance on financial arrangements for self-lay and requisitioning agreements

1 Purpose

The Water Act 2003 (WA03) received Royal Assent on 20 November 2003. This changes the ways in which water and sewerage companies¹ reach agreement with developers about installing new water mains, service pipes and sewers. The relevant provisions come into force on 28 May 2004 and amend the Water Industry Act 1991 (WIA91). All references to the WIA91 in this document are references to the Act as amended by the WA03.

This guidance explains the principles that water and sewerage companies should follow when calculating the charges and payments that are made when new water and sewerage infrastructure is installed.

2 Background

2.1 Provisions relating to installing new infrastructure

When a new water main or sewer is needed the owner or occupier of the premises needing the new supply can ask the water or sewerage company to install the pipework. When a new water supply or sewer is required for domestic purposes, this is known as requisitioning.

Under the WIA91, there are two mechanisms for paying for requisitions. Requisitioners can make yearly payments to water and sewerage companies for up to 12 years, the relevant deficit option. Alternatively, the requisitioner can pay a statutory commuted sum, the discounted aggregate deficit. These charges are explained further in section 3.1 below.

Alternatively the owner or occupier of the premises may choose their own contractor to carry out the work. This is known as 'self-lay'.

Under the WIA91, water companies are able to enter into agreements with persons constructing or proposing to construct new water mains and service pipes². If the pipes are constructed in accordance with the terms of the agreement, the water company must connect them to the existing network and take over responsibility for (adopt) them. When a main is built to supply water for domestic purposes and the water company adopts it, the WIA91 requires water companies to make a payment in recognition of the revenue that will be recovered from newly connected properties. The payment will be made to the person who enters into a self-lay agreement with the water

¹ Water or sewerage companies are companies who hold Instruments of Appointment as water or sewerage undertakers under the Water Industry Act 1991 (WIA91)

² Section 51A(1) of the WIA91

company³. This can be either a developer or their contractor. This payment is explained further at section 3.2 below.

There is no specific provision covering the installation of pipes by self-lay organisations (SLOs) to supply water for non-domestic purposes. But under the WIA91, a water company can agree to take responsibility for these pipes if a third party lays them. Principles 3 and 13 explain the policies relating to installing pipes to supply water for non-domestic purposes.

This guidance explains payments for requisitioned sewers. It also explains why sewerage companies should not make a payment to developers for self-laid sewers. However, it does not cover any charges for self-laid sewers that are referred to in the WRc publication 'Sewers for Adoption'. This is a guidance document published by agreement between sewerage companies and the construction industry.

We expect water and sewerage companies to publish transparent information about the policies that they operate.

2.2 Dispute handling powers

Under the WIA91 we have powers to determine disputes. We will consider each case on its merits but this guidance provides a framework for us to consider these disputes. In general, we expect water and sewerage companies to follow this guidance and our earlier guidance on 'Competition in providing new water mains and service pipes' which we published in March 2002. When deciding the outcome of disputes, we will take into account whether the water and sewerage company's policies meet the principles that we have set out in these documents.

We can determine disputes in the following areas:

- Financial conditions of water and sewer and lateral drain requisitions. This will include disputes about the level of security and charges for the work.
- Completion date and route of requisitioned water mains or sewers and lateral drains.
- Water companies' refusals to enter into agreements to adopt self-laid water mains and the terms and conditions of such agreements.
- Financial conditions of agreements to self-lay water mains, including the level of security and charges for the work.

Our process for considering these disputes is set out in our guidance 'Process for handling disputes and appeals'.

³ Section 51C(1) and (5) of the WIA91

This document is not a substitute for the WIA91 or any other relevant legislation. It should be read in conjunction with the relevant legislation. Anyone in doubt about how the legislation may affect them should seek independent legal advice.

2.3 Consultation process

In December 2003 we consulted on the framework of the new legislation. Respondents generally supported the proposals in the consultation paper. This paper sets out the finalised principles and the methodologies that we expect water and sewerage companies to follow and will take effect from 28 May 2004.

The responses to the consultation are summarised in the document called 'Consultation on financial arrangements for self-lay and requisitioning agreements: summary of responses and our conclusions'. The consultation respondents are listed as an annex to that document.

In January 2004 we held a self-lay and requisitioning workshop. This provided an opportunity for stakeholders, organisations and individuals from the industry to discuss some of the issues raised in the consultation paper. We have also discussed the principles set out in this paper with our industry advisory group, the self-lay group (SLG). This group includes representatives from water and sewerage companies, developers and contractors.

2.4 Structure of the guidance

Section 3 explains the charges that are made when new water mains for domestic purposes are installed. Annex B is a worked example of the charges that will be made for a hypothetical development.

Section 4 below sets out the principles water companies should follow when calculating the components of these charges.

Section 5 explains how water companies should complete a cost breakdown template for each job, detailing the charges and payments that may be made when work is self-laid.

Sections 6 – 8 set out the principles that water companies should follow when calculating security, payments for installing supplies for non-domestic purposes and payments for installing sewers.

Section 9 explains the definitions of infrastructure charges and network reinforcement and sets out how we will consider these costs if any disputes are referred to us.

Section 10 sets out our decisions on setting the interest rates for requisitioning.

In the final section we explain the framework for charging for new infrastructure when a new licensee enters the market.

The finalised regulatory impact assessment is included as annex E.

3 Installing new water mains and service pipes to supply water for domestic purposes

Water companies will need to either calculate actual costs or estimate notional costs to produce the charges or payments for installing new water mains and service pipes. This section outlines how charges should be calculated or estimated in accordance with the WIA91.

If a developer enters into an agreement with a water and sewerage company about installing a main or sewer outside the provisions of the WIA91, we will not be able to intervene in any dispute about the terms and conditions of such an agreement.

3.1 Charges for installation when the water company installs the new pipes

Water companies should calculate requisitioning charges based on the following.

- a) Water companies are entitled to recover the costs reasonably incurred in providing the new water main⁴. This includes, among other things, the reasonable costs of design, labour, plant, materials, reinstatement, quality testing, inspection, supervision and administration costs. But we do not consider that this amount should include any allowance for profit. Under the WIA91, there is no provision for water companies to recover a rate of return on their charges for this work.
- b) The WIA91 also provides that water requisitioning charges can include any costs reasonably incurred in providing other water mains and any tanks, service reservoirs and pumping stations that are needed because of the provision of the new main⁵. These costs can be known as network reinforcement.
- c) The water company can also charge the requisitioner a reasonable proportion of costs reasonably incurred in providing additional capacity in some existing mains, where this is used because of the new main⁶.
- d) However, requisitioning charges do not include the costs of laying and connecting communication pipes (usually the part of the service pipe between the main and the boundary of the highway in which the main lies). The costs of this work should be recovered separately under section 45 of the WIA91.

⁴ Section 43(2) of the WIA91

⁵ Section 43(4)(a) of the WIA91

⁶ Section 43(4)(b) of the WIA91

- e) Similarly, the requisitioning charges do not include the costs of any pipe diversions that the water company has been asked to make under section 185 of the WIA91, which water companies can recover separately.
- i) Paying for requisitions

The WIA91 requires the water company to offer the developer the following payment choices.

Relevant deficit charges

The relevant deficit is defined as the amount (if any) by which the annual borrowing costs of a hypothetical loan for the cost of providing the new main exceeds the revenue for that year from customers connected to that main⁷. The relevant deficit is calculated and payable over a period of 12 years after the main has been provided so it is based on the actual costs of carrying out the work.

The water company is not required to make a payment to the requisitioner when the revenue from the newly connected premises exceeds the costs of financing the new main. At this point, the relevant deficit becomes zero. Because of this, the allowance that is made for revenue will not equal the actual revenue received if this is higher than the annual borrowing costs of a loan. The capped level of revenue that is used to calculate requisitioning charges (and asset payments which are explained below) is referred to in this document as the income allowance.

See the worked example at annex B.

Payment by statutory commuted sum

Developers can also pay for mains using the discounted aggregate deficit method, which is a single statutory commuted sum. The WIA91 states that this is an amount equal to the sum of the estimated relevant deficits for each of the 12 years following the provision of the main, in each case discounted to a net present value⁸.

The finalised statutory commuted sum is payable when the work has been completed and the actual costs of the work are known⁹. These costs should be used to calculate the finalised statutory commuted sum charge. This amount may include an amount for network reinforcement (see section 9). To complete the calculation of the statutory commuted sum the water company will have to estimate the costs of a hypothetical loan and the revenue that it will receive from newly connected properties.

However, before the work is carried out and the actual costs are known, the water company will need to estimate the statutory commuted sum, including the costs of carrying out the work in order to complete the cost breakdown

⁷ Section 43(1) of the WIA91

⁸ Section 43A(1) and (6) of the WIA91

⁹ Section 42(2)(a)(ii) of the WIA91

template (see principle 9 and annex C). So once the main has been provided and the actual costs of the work are known, the finalised statutory commuted sum charge may vary from the original estimated commuted sum charge.

Once the finalised statutory commuted sum has been paid, water companies cannot recalculate the amount and ask for more money. When the finalised statutory commuted sum has been calculated, including any amount for network reinforcement, any dispute about the amount of the statutory commuted sum can be referred to us for determination¹⁰.

Water companies should refer to the relevant principles set out in section 4 to calculate the relevant deficit and statutory commuted sum.

ii) Infrastructure charges

In addition to the requisitioning charges, a developer will also have to pay an infrastructure charge for each new connection to a main. An infrastructure charge is a fixed charge that is usually payable each time a new connection for domestic purposes is made¹¹.

Infrastructure charges are explained further in section 9.

3.2 Charges when the new pipes are self-laid

When a person requiring a new main for domestic purposes enters into an agreement with a water company to self-lay these pipes, there will be various charges and payments for the work.

We would usually expect the agreement to be between the developer and the water company. For this reason, we have used the term developer in the following text although it also applies to circumstances where, other parties, such as contractors carrying out the work, enter into agreements with water companies.

- a) The developer will normally pay the water company charges for any non-contestable or contestable work that the water company has completed. It may also include an amount to cover costs equivalent to those explained at paragraphs 3.2 b) and c)¹².

A definition of contestable and non-contestable is included in the glossary at annex A and a list of contestable and non-contestable work is at annex D.

- b) The developer also has to pay the contractor for installing the mains.

¹⁰ Section 42 (6) of the WIA91

¹¹ Companies are entitled to make such a charge under section 146(2) of the WIA91

¹² Section 51C(3) of the WIA91

c) The water company will have to pay the developer an asset payment¹³. This payment is an allowance for the revenue that the water company will receive from the properties connected to the new main.

i) Calculating the asset payment

Under the WIA91 the asset payment is calculated as the sum of the estimated offsets for each of the 12 years following the adoption of the main in each case discounted to a net present value¹⁴. The offset is the lesser of the estimated revenue from the adopted main or the annual borrowing costs of a hypothetical loan for the costs of providing the main. This mechanism ensures that the revenue is capped in the same way as when requisitioning charges are calculated. (See the explanation in section 3.1i)

The asset payment is payable when the main is vested in (adopted by) the water company¹⁵. The calculation is based on estimates of the annual borrowing cost and the revenue that will be received from newly connected properties as well as water companies' estimates of how much the overall cost of the work would have been if they had carried out the work themselves as part of a requisition.

Before the work is carried out, the water company will need to estimate the asset payment in order to complete the cost template at annex C. Once the work has been carried out and the asset payment becomes due, the finalised calculation may be adjusted to account for changes in estimates of revenue or the overall costs of the work. For this reason, the finalised asset payment may vary from the original estimated asset payment.

Once the asset payment has been made, the water company cannot make any further adjustments to the sum.

Water companies should follow the relevant principles set out in section 4 when calculating the asset payment.

Disputes about the level of the asset payment can be referred to us for determination¹⁶. We can consider these disputes after the work has been completed and the payment becomes payable.

ii) Infrastructure charge

The developer will have to pay an infrastructure charge for each new connection. Infrastructure charges are explained in section 9.

¹³ In the WIA91 this is referred to as the discounted offset amount.

¹⁴ Section 51C(6) and (9) of the WIA91

¹⁵ Section 51C(5) of the WIA91

¹⁶ Section 51C (11) of the WIA91

4. Principles for calculating the components of charges and payments for requisitioning and self-lay of water pipes

4.1 Estimating the costs of the work

Principle 1: Water companies' estimates should be based on robust and transparent information about the anticipated costs of the work. Developers should provide timely and reliable information about the work that is needed so that water companies can provide estimates that are as accurate as possible.

Before the work is carried out, water companies will need to estimate the requisitioning charges and the asset payment in order to provide the information requested on the cost template and to enable them to calculate any security that they may require. Water companies should produce transparent and robust estimates of the cost of the work.

Estimates should include transparent costings for all aspects of the work that water companies will carry out.

There may be some costs that are incurred solely as a result of the work being self-laid. Water companies can recover their reasonable costs for this work. They should explain clearly at the beginning what costs may be incurred in this way.

When developments are large or will be completed in several phases it will be more problematic for water companies to produce accurate estimates. In these situations, developers should provide water companies with information in a timely manner to enable the water companies to develop an overview of the demand from the site in the long-term. Developers can then apply for new infrastructure in phases to mirror the completion of the development. In this way, water companies may be able to produce more accurate estimates.

4.2 Calculating the asset payment

Principle 2: Water companies should assess the components of the charges and payments in the same way whether they are estimating or calculating the asset payment or estimating or calculating the requisition charges.

When the revenue and the annual borrowing costs are calculated for the purpose of producing the asset payment, they should be calculated as if the work had been requisitioned¹⁷. For consistency, estimates should also be made in the same way. This will enable developers to compare the cost of self-lay with the cost of requisitioning.

When the water company calculates or estimates the asset payment, it will need to produce a notional figure for the overall costs of the work. This should be the same as the water company's estimate of the costs it would incur if the work was requisitioned.

¹⁷ Section 51C(8) of the WIA91

There will be situations where the water company incurs costs solely because the work is being self-laid, as mentioned under principle 1 above. Where this occurs, these figures do not need to be included in the assessment of the notional total overall costs for the purpose of calculating the asset payment. (The water company can recover the actual costs of this work separately as part of the charges that the developer pays to the water company for the work that the water company carries out.)

The asset payment should be calculated in the same way whether the work is part of a single pipe or a multiple pipe installation.

For consistency, water companies should take account of the same criteria when they calculate or estimate the asset payment as they would when calculating or estimating requisitioning charges. For instance, water companies may take account of periods when they will not receive any revenue when calculating the requisitioning charges, for example where there are a number of holiday homes in the area. They should take account of these factors in the same way when calculating the asset payment.

4.3 Estimating the revenue

Principle 3: Estimates of revenue should be calculated on the basis of the average metered charge per property. Water companies should take account of the future revenue that will be recovered from supplies for non-domestic purposes, where this can be assessed.

Water companies should consider regional variations in average water consumption, where this information is available. Water companies should make it clear what factors they consider when assessing the revenue they will recover.

The WIA91 states that when calculating the relevant deficit and statutory commuted sum, the revenue that should be taken into account includes charges that are reasonably attributable to providing a supply of water, whether or not that supply is for domestic purposes¹⁸.

It should be noted that supplies to commercial properties are not necessarily supplies for non-domestic purposes. Supplies of water for drinking, washing, cooking, central heating and sanitary purposes are supplies of water for domestic purposes even if, apart from some specific exceptions, the use of the property is commercial¹⁹.

We recognise that it may be more difficult to assess consumption from supplies for non-domestic purposes.

As mentioned above, the revenue to be taken into account should be that which is 'expected to be payable' to the water company for the provision of a supply of

¹⁸ Section 43(7)(a)(ii) and Section 43A(4)(a)(ii) of the WIA91

¹⁹ Section 218 of the WIA91

water²⁰. When we consider disputes about the level of charges or payments for installing new infrastructure we will have regard to whether the revenue is 'expected to be payable'. We will normally expect water companies to take reasonable steps to ensure that their estimates are robust. We acknowledge that it may be problematic to assess the likely revenue and will take this into account as appropriate.

Water companies should make it clear in their published literature what average charges they use and what factors they will consider when assessing the revenue that they will receive.

4.4 Calculating the revenue for the purposes of calculating the relevant deficit

Principle 4: The relevant deficit should be calculated on the basis of the revenue that is payable, not the revenue that has been received from a newly connected property.

When the relevant deficit is calculated, water companies have to refer to the actual income that they can recover from a property. Water companies should calculate the relevant deficit using the amount of revenue that is payable, which is usually equal to what has been billed and not the revenue that has been received. Similarly, when the revenue is estimated, water companies should estimate how much revenue will be payable, not how much income will be recovered.

Water companies should make an assessment of when income becomes payable (see principle 8).

4.5 Proportion of revenue that is allocated as income allowance

Principle 5: Water companies should allocate 100% of the revenue from newly connected premises as the income allowance.

When calculating the charges and payments for installing new infrastructure, water companies should use 100% of the water charges that will be levied for premises connected to that main for each of the next 12 years.

4.6 Applying a discount rate

Principle 6: The discount rate that water companies use should be the same as the rate of interest for borrowing.

Section 10 explains how the rate of interest for borrowing should be calculated. Setting the discount rate at the same level as the rate of interest for borrowing means that the calculations of the relevant deficit, statutory commuted sum and asset payment are made on a consistent basis.

²⁰ Section 43A(4) of the WIA91

The discount factor should be applied from the first year onwards, as set out in the worked example at annex B.

4.7 Applying a rate of inflation and adjustment factor (K)

Principle 7: Water companies should forecast the long-term effects of inflation and adjustment factor (K) on anticipated revenue when calculating the statutory commuted sum charge or the asset payment.

Each year water companies are allowed to increase their average water charges by no more than RPI + K. RPI is the retail price index which is the measure of the rate of inflation and K is the price limit that we set for each water company for each year of a five year period.

Water companies should use the forecasts which are compiled by the Treasury to provide a figure for long-term inflation. The relevant publication is called 'Forecasts for the UK economy: a comparison of independent forecasts'.

Water companies should apply the inflation rates and K factors that are available for the years that these apply and thereafter make a reasonable assessment of likely changes.

4.8 Estimating when the income becomes payable

Principle 8: Water companies should take account of developers' submissions to estimate when income starts to become payable for a property.

Under the WIA91, water companies need to estimate the level of payable charges so that they can calculate the statutory commuted sum and asset payment²¹. When calculating the statutory commuted sum, water companies should start to estimate how much revenue will become payable from the point that the main is provided. When calculating the asset payment, they should assess this from the time that the main is adopted.

There are several different factors which affect this assessment, including the build rate, the connection rate, the occupancy rate and when the charges become payable. (These terms are defined in the glossary.) It is reasonable for water companies to rely on their own information to make an assessment of when the charges become payable. Water companies should explain what assumptions they make when assessing what charges become payable. They should also be flexible and review their assumptions if asked to by the developer or if the developer provides robust information suggesting that a water company's assumptions are wrong.

Generally we would consider that charges become payable at the point at which the water company can issue a bill, although the bill may not be physically issued until a later date.

²¹ See sections 43A(4) and 51C(8) of the WIA91

5 Non-contestable costs

Principle 9: Water companies should complete a cost breakdown template for each job, including all the costs of non-contestable elements of self-lay work and the estimates for statutory commuted sums and asset payments.

The cost breakdown template at annex C sets out the charges for non-contestable work that the water company may make (see annex D for a list of non-contestable work) and also the asset payment that the water company will pay the developer if a developer chooses to self-lay. For comparative purposes, the water companies should also include their estimates of the statutory commuted sum and relevant deficit payments.

6 Security

Principle 10: Water companies should not insist that security be provided in one particular form but should offer a choice of payment methods to the developer.

Under the WIA91, water companies are entitled to ask for security before installing new mains in response to a requisition and we have powers to determine disputes about the security that a water company requires²².

Water companies should offer a range of options for paying security but it is for the water companies to decide which security options they wish to offer.

There may be additional overheads associated with administering certain security methods. Water companies should explain clearly at the start of the application process what extra costs will be incurred.

Principle 11a: When works are requisitioned and the water companies require an undertaking or security, the water company should ask for no more than 100% of the estimated statutory commuted sum unless there are justifiable reasons for doing so.

Principle 11b: The undertaking or security should be returned within six months of the relevant deficit becoming zero, or when the finalised statutory commuted sum is paid unless the water company can provide justifiable reasons for holding the security for longer.

Under the WIA91, the statutory commuted sum will be payable when the works have been completed and the relevant deficit is payable over 12 years. It is reasonable for water companies to require a security to cover the risk that they may not recover their requisition charges.

In most cases, the level of security will not need to be more than the estimated statutory commuted sum. However, in some circumstances, there may be an additional risk to water companies, for example with larger, multi-phased

²² Section 42(6) of the WIA91

developments or developments where the use of properties is largely commercial and therefore annual revenue is less predictable. In these circumstances it may be reasonable for water companies to require extra security or to hold on to the security after the relevant deficit has reached zero or the statutory commuted sum has been paid. In these cases, water companies should state clearly what their policies are and what increased costs the requisitioner will incur. If any dispute about the level of security is referred to us, we will consider whether the water companies' policies are reasonable.

When the work has been completed, water companies should review how much security they are holding and the level of risk that still remains. Where appropriate, water companies should return excess security to the requisitioner at this stage. Water companies should pay interest on any security that they hold for the length of the time that they hold it in accordance with the rates that we issue – see section 10.

Principle 12a: When a water company requires security for self-laid works, this should cover the reasonable potential cost of remedying minor defects in the SLO's work and the reasonable costs of the non-contestable work, where these have not already been recovered.

Principle 12b: This security should be held until the SLO has paid the charges for the work that has been carried out and the defects liability period or maintenance period is over.

Water companies will not adopt any self-laid pipes unless they have been installed to their required standards. For this reason, the risk to the water company of having to remedy defects should be low and the cost of this should not be as high as the overall costs of installing the new mains. Where water companies ask for higher levels of security, they should have robustly justifiable reasons for doing so.

As mentioned above, water companies should pay interest on any security that they hold for the length of the time that they hold it in accordance with the rates that we issue – see section 10. If appropriate, water companies should consider returning the deposit to the developer in staged payments to reflect the reduction in risk to the water companies.

7 Supplies for non-domestic purposes

Principle 13: Water companies should consider developers' requests to self-lay non-domestic supplies. Water companies do not need to make an asset payment for self-laid mains for wholly non-domestic purposes.

Supplies for non-domestic purposes are water supplies that are for purposes other than those defined as domestic purposes in the WIA91. The definition of supplies for domestic purposes is explained under principle 3. Under WIA91 water companies are not prevented from agreeing to take responsibility for a main that has been installed, in whole or in part, for non-domestic purposes.

Water companies should allow developers the choice of using their own contractor to lay mains to supply water for non-domestic purposes and agree to take responsibility for the pipes once the work is completed to the required standard. The pipe will be vested in (adopted by) the water company in the same way as under an agreement to adopt self-laid pipes that are supplying water for domestic purposes²³.

When a developer asks a water company to provide a supply of water for non-domestic purposes, the water company is entitled to recover its expenses and, where appropriate, a reasonable return on its capital²⁴. Unlike the requisitioning of mains for domestic purposes, however the water company does not have to make an allowance for the future revenue that will be received from customers connected to that main. So when a developer lays a main for solely non-domestic purposes, the water company does not need to make an asset payment.

Frequently, however, a developer may require a supply for both domestic and non-domestic purposes. Where the developer lays a main for a supply for both purposes, the water company should make an asset payment in respect of the proportion of the supply that is for domestic purposes.

8 Installing new sewers

8.1 Charges for installation of new sewers by the sewerage company

Sewerage companies should calculate requisitioning charges based on the following.

- a) Sewerage companies are entitled to recover the costs reasonably incurred in providing the new sewer²⁵. This includes, (among other things) the reasonable costs of design, labour, plant, materials, reinstatement, inspection, supervision and administration costs. But we do not consider that this amount should include any allowance for profit. Under the WIA91, there is no provision for sewerage companies to recover a rate of return on their charges for this work.
- b) The WIA91 also provides that sewer requisitioning charges can include any costs reasonably incurred in providing other public sewers and such pumping stations as it is necessary to provide in consequence of the provision of the new sewer²⁶. These costs can be known as network reinforcement.
- c) The sewerage company can also charge the requisitioner a reasonable proportion of the costs reasonably incurred in providing additional

²³ Section 51A(2) of the WIA91

²⁴ Section 56 of the WIA91

²⁵ Section 100(2) of the WIA91

²⁶ Section 100(4)(a) of the WIA91

capacity in existing sewers that were previously requisitioned, where this is used because of the new sewer²⁷.

d) The sewerage company will also have to provide lateral drains if asked to by the requisitioner and the costs of this work can be recovered in the same way.

i) Relevant deficit charges

The relevant deficit charge for sewer requisitions is defined as the amount (if any) by which the drainage charges payable for the use during the year of that sewer are exceeded by the annual borrowing costs of a hypothetical loan of the amount required to provide the sewer²⁸.

The relevant deficit charge is calculated using broadly the same methodology as for water main requisitions, but taking into account the drainage charges that will be received from newly connected properties. When a sewer is requisitioned, whether this is on-site or off-site, sewerage companies should take account of the revenue that will be received from newly connected properties.

ii) Payment by statutory commuted sum

The statutory commuted sum payment is calculated using a similar methodology as for water main requisitions²⁹.

iii) Infrastructure charges

Infrastructure charges are also payable for sewerage services. See section 9.

8.2 Principles for calculating charges for installing sewers

The principles that sewerage companies should follow when calculating the components of requisitioning charges are outlined below.

See also the worked example at annex B.

Principle 14: Sewerage companies' estimates of relevant deficit and statutory commuted sum charges for sewer requisitions should be based on robust information and calculated consistently.

- **Developers should provide timely and accurate information to enable sewerage companies to provide these estimates.**
- **Estimates of revenue should be based on the average sewerage charge per property.**

²⁷ Section 100(4)(b) of the WIA91

²⁸ Section 100(1) of the WIA91

²⁹ See section 100A of the WIA91

The drainage charges that sewerage companies should take into account when calculating the requisition charges are those which relate to the premises that are connected to the sewer and are reasonably attributable to the use of that sewer for the drainage for domestic sewerage purposes or the disposal of effluent from those premises³⁰. The assessment of future revenue does not need to take account of any charges for trade effluent or highway drainage.

Principle 15: Principles 4 – 8 relating to the calculation of charges for requisitioning water mains should be applied to the calculation of sewer requisitions charges.

These principles apply taking into account the following comments.

- The relevant deficit should be calculated on the basis of revenue that is payable, not the revenue that has been received from a connected property.
- The discount rate that sewerage companies use should be the same as the rate of interest for borrowing. The interest rate for borrowing is explained further in section 10.
- Sewerage companies should forecast the long-term effects of inflation and K on anticipated revenue when calculating the statutory commuted sum.
- Sewerage companies should use developers' submissions to assess when income starts to become payable for a property.

Principle 5 applies to sewers in a slightly different way, as follows.

- Sewerage companies should allocate 100% of the sewerage charges for connected premises as the income allowance, where this is not income for trade effluent or highway drainage.

Principle 16: When calculating the charges for self-laid sewers, sewerage companies should not pay developers an asset payment.

If the developer decides to lay sewers themselves under section 104 of the WIA91 for connection directly to an existing public sewer the sewerage company cannot recover a charge for network reinforcement. Hence it would not be possible to calculate the income allowance on a consistent basis.

Principle 17: When sewers are requisitioned and the sewerage company requires security, the sewerage company should ask for no more than 100% of the estimated statutory commuted sum unless there are justifiable reasons for doing so.

In some circumstances it may be reasonable for sewerage companies to require extra security or to hold on to the security after the relevant deficit has reached zero

³⁰ Section 100(7) of the WIA91

or the statutory commuted sum has been paid. In these cases, sewerage companies should state clearly what their policies are and what increased costs the requisitioner will incur. Under the WIA91, sewerage companies are entitled to ask for security before installing new sewers in response to a requisition and we have powers to determine disputes about the security that a sewerage company requires³¹. If any dispute about the level of security is referred to us, we will consider whether the sewerage companies' policies are reasonable.

When the work has been completed, sewerage companies should review how much security they are holding and the level of risk that still remains. Where appropriate, sewerage companies should return excess security to the requisitioner at this stage, applying the appropriate level of interest.

9 Infrastructure charges and network reinforcement costs for water main and sewer installation

Principle 18: When considering disputes about the level of charges for network reinforcement we will take account of the infrastructure charges that have been or will be raised for that development.

Water and sewerage companies should be able to recover the full costs from developers that they have incurred in servicing the relevant development but no more.

9.1 Network reinforcement

The WIA91 provides that water requisitioning charges can include any costs reasonably incurred in providing other water mains and any tanks, service reservoirs and pumping stations that are necessary because of the provision of the new main³².

The WIA91 also provides that sewerage requisitioning charges can include any costs reasonably incurred in providing other public sewers and any pumping stations that are necessary because of the provision of the new sewer³³.

These costs are commonly known as network reinforcement. Under the WIA91, we have the powers to determine disputes about the reasonable levels of requisitioning charges, including costs of network reinforcement relating to either water or sewer requisitions. In considering these disputes we will want to see the water and sewerage companies' data in support of their claims for network reinforcement costs. This could include:

- Modelling of the supply zone or sewer catchment showing the estimated effects of the proposed development on the adequacy of the infrastructure to supply or drain to existing and new customers.

³¹ Section 99(6) of the WIA91

³² Section 43(4)(a) of the WIA91

³³ Section 100(4)(a) of the WIA91

- Any evidence indicating that there is not adequate capacity in the existing network to supply or service the new development. For example, we could refer to complaints about low pressure from existing customers or properties on the DG2 register. This is the register of low pressure indicators that water companies must report on.
- Where network reinforcement is applicable to two or more developers an explanation of how the costs are apportioned between each developer.

Where the water or sewerage company upgrades a main or sewer to take account of anticipated future developments, it can only recover from the developer the costs associated with the network reinforcement relating to the current development.

Where a water or sewerage company has previously enhanced the water supply network or sewerage service in response to a statutory requisition in the previous 12 years and provided additional capacity used because of the new main or sewer, the water or sewerage company may recover from the developer the appropriate proportion of the costs of that network enhancement. (A water company will also be able to recover an appropriate proportion of any costs that it incurs in paying a developer to provide additional capacity in a self-laid main that is vested in the water company by virtue of a declaration under Chapter II of Part III of the WIA91.)

9.2 Timescale for recovery of costs

Water and sewerage companies may only recover the costs of work **necessary** to reinforce the network. We therefore think it is unlikely that any such work would be carried out more than a year after the self-laid main or requisitioned main or sewer has been installed. In determining relevant disputes, we will consider carefully whether the network reinforcement was necessary particularly where water or sewerage companies seek to recover the costs of reinforcement that took place more than a year after the main or sewer has been installed.

There may be circumstances where a large site is developed in phases and infrastructure is therefore requisitioned (or, in the case of water mains, self-laid) in stages. The network reinforcement could be necessary at the first stage or at a later stage (which could be one or more years later) as a result of another requisition (or self-lay installation).

9.3 Infrastructure charges

The WIA91 entitles a water or sewerage company to raise a charge where connections for water supplies or sewerage services for domestic purposes are made for the first time to premises³⁴. This is regardless of who carries out the work. This is known as the infrastructure charge. In our approach to setting price limits we consider infrastructure charges as a contribution to the costs of enhancing the local network of mains and sewers. The Director set the infrastructure charge limit for a standard connection at £200 at the 1995 periodic review and it has subsequently increased in line with inflation. He explained at the time that infrastructure charges are a contribution towards the costs of local system enhancement (ie the distribution

³⁴ Section 146(2) of the WIA91

system) only, and should not therefore be financing the costs of, for example, water treatment or water resources³⁵.

In considering costs reasonably incurred for network reinforcement, we will take account of infrastructure charges payable for premises on the relevant development.

In considering disputes we will require water or sewerage companies to explain to us what costs they have incurred in installing infrastructure that they have not recovered through infrastructure charges. This is to ensure that there is no over-recovery of costs – we will still expect that water and sewerage companies will be able to recover their full costs for this work.

10 Interest rates for requisitioning – borrowing and deposits

The interest rates for borrowing and deposits are linked to the ten year gilt yield. We add premiums to this figure to calculate the rate of interest for borrowing and deposits. The premiums that we assume will stay the same until the outcome of the current periodic review. We will review at that point the level of premiums that we should apply. We will continue to notify the industry of changes in interest rates by issuing RD letters. We will not ask for changes to be applied retrospectively.

11 Charging for new infrastructure when a new licensee enters the market.

The WA03 also creates a framework for companies that want to compete with existing water companies to supply non-household customers who consume at least 50Ml/yr by gaining a water supply license. Customers of the water supply licensee (WSL) can requisition water mains to provide supplies for domestic purposes if they are owners or occupiers of any premises in a locality. If such a requisition is made, the water company will still need to calculate the revenue for the purposes of calculating the relevant deficit or commuted sum. Where a customer is a customer of the licensee this calculation should take account of the fact that the charges recovered by the water company in relation to the supply of water will be different from the charges recovered from its own customers³⁶.

Where the water company is aware that customers with a supply of water from a requisitioned main will shortly be switching to a WSL, it can take account of this when estimating revenue for the purposes of calculating the charges and payments for new infrastructure. However, the water company would need to be able to demonstrate the fact that the customer is switching. (In calculating relevant deficits, water companies will be able to take into account what has **actually** occurred.)

³⁵ See RD 2/95

³⁶ This is set out in section 43(7) and 43A(4) of the WIA91

Annex A Glossary of terms

Annual borrowing cost

The total amount of interest and repayments of capital which have to be paid in any year.

Asset payment

The payment made on adoption of the mains to people who self-lay supplies for domestic purposes in recognition of the future revenue that is payable for supplies of water to customers connected to the newly installed main. This is referred to as the discounted offset amount in the WIA91.

Build rate

The rate at which properties on new development sites are built.

Connection rate

The rate at which properties on new development sites are connected to the water company's network.

Contestable

Open to competition.

Developers

Those who organise the purchase of land, construction of new buildings and their sale.

Discounted aggregate deficit

See statutory commuted sum.

Discounted offset amount

See asset payment.

Disinfection

Water is treated with, for example, small amounts of chlorine to ensure that it complies with water quality regulations.

Domestic purposes

In relation to water supplies, domestic purposes includes the use of water for drinking, washing, cooking, central heating and sanitary purposes (with certain exceptions). The term is defined more fully in section 218 of the WIA91.

Easement

Legal right of way over another person's property, which may cover the laying of pipes.

Income allowance

The revenue that is taken into account when charges for requisitioning and payments for self-lay are calculated. If the revenue is higher than the annual borrowing cost then the income allowance is capped at the level of the annual borrowing cost.

K factor

K is the number determined by the Director every 5 years for each water company for each year to reflect what it needs above inflation in order to finance the provision of services to customers.

Lateral drain

The part of a drain that runs from the curtilage of a building or premises to a sewer.

Multiple-lay installation

When more than one utility service is laid in a single trench.

Non-contestable

Not open to competition.

Non-domestic purposes

Water supplies that are for purposes other than those defined as domestic purposes in section 218 of the WIA91. This includes for example the use of water for the purposes of the business of a laundry or a business of preparing food or drink for consumption off the premises.

Occupancy rate

The rate at which properties are occupied after they have been built.

Off-site

In the public highway or in land owned by people other than developers.

On-site

Land owned by developers.

Periodic review

The process of re-setting all water companies' price limits. Price limits are set every five years.

Reinstatement

Work carried out to restore the surface of the ground to its original condition. For example, resurfacing a road after work to lay water mains.

Relevant deficit payments

Where developers requisition new mains for domestic purposes under sections 41 to 44 of the WIA91, they may pay for these over 12 years (the "relevant deficit" payments). The payments are calculated under section 43. Similarly where developers requisition new sewers for domestic sewage purposes under section 98 – 101 of the WIA91 they may pay for them over 12 years.

Requisition

Water companies must (subject to certain conditions) provide water mains that are sufficient for domestic purposes when requested to do so by a notice under section 41 of the WIA91. This is known as a requisition, water companies must provide the mains once the financial conditions of compliance are satisfied and the places for

connecting the new pipes to its existing mains/network have been agreed. Similarly, when sewerage companies are asked to provide new sewers by a notice under section 98 of the WIA91, this is known as the requisition of a sewer.

Revenue

The charges payable to the water or sewerage companies for their services.

Security

A deposit or other guarantee which a water or sewerage company may ask a person requesting a main or sewer to provide against the charges that they will have to pay to the water or sewerage company when the main or sewer is provided.

Self-lay

Where developers, or their contractors, install new water mains and service pipes instead of asking the water company to do the work.

Self-lay organisations (SLOs)

These include developers who can lay their own mains and service pipes, contractors laying mains for the developers, and multi-utility infrastructure providers.

Service pipes

A pipe supplying water from a water main to any premises (whether in the highway or in private land).

Statutory commuted sum

A single payment that is made by a developer to a water or sewerage company for laying new water mains or sewers. This is paid as an alternative to relevant deficit payments (see above). This is referred to as the discounted aggregate deficit in the WIA91.

Swabbing

A process to clear mains of dirt and materials before they are filled with water.

Annex B

Worked example of calculating the relevant deficit, statutory commuted sum and asset payment

Please note. This worked example is intended to be an explanation of the methodology that should be used to calculate charges. As such it is an example only and is simplified. Water and sewerage companies should have regard to this methodology but follow the principles set out in the guidance document when calculating the charges and payments.

Variables	
Total scheme cost	£98,000
Number of properties	114
Average income per property	£96.00
Interest rate for borrowing	6.75%
Discount rate	6.75%
Long term annual inflation	3.0%
Number of applicable years	12

The projected future revenue is the number of properties connected in the relevant year, (based on a cumulative occupancy) multiplied by the income per property that will be received and increased each year in line with inflation.

Calculation of relevant deficit for the installation of water and sewerage infrastructure

Year	Projected future revenue	Annual borrowing costs	Income allowance	(Projected) relevant deficit
1	£ 2,208.00	£12,174.52	£2,208.00	£9,966.52
2	£4,548.48	£12,174.52	£4,548.48	£7,626.04
3	£8,758.79	£12,174.52	£8,758.79	£3,415.73
4	£11,958.80	£12,174.52	£11,958.80	£215.71
5	£12,317.57	£12,174.52	£12,174.52	-
6	£12,687.10	£12,174.52	£12,174.52	-
7	£13,067.71	£12,174.52	£12,174.52	-
8	£13,459.74	£12,174.52	£12,174.52	-
9	£13,863.53	£12,174.52	£12,174.52	-
10	£14,279.44	£12,174.52	£12,174.52	-
11	£14,707.82	£12,174.52	£12,174.52	-
12	£15,149.06	£12,174.52	£12,174.52	-
Total	£137,006.03	£146,094.22	£124,870.22	£21,224.00

Calculation of statutory commuted sum for the installation of water and sewerage infrastructure

Year	(Projected) relevant deficit	Discount factor	Statutory commuted sum
1	£9,966.52	0.93677	£9,336.32
2	£7,626.04	0.87753	£6,692.11
3	£3,415.73	0.82205	£2,807.89
4	£215.71	0.77007	£166.11
5	-	0.72137	-
6	-	0.67576	-
7	-	0.63303	-
8	-	0.59300	-
9	-	0.55551	-
10	-	0.52038	-
11	-	0.48748	-
12	-	0.45665	-
Total	£21,224.00	8.04960	£19,002.43

Calculation of the asset payment that is made for self-laid water mains for domestic purposes

Year	Income allowance	Discount factor	Asset payment
1	£2,208.00	0.93677	£2,068.38
2	£4,548.48	0.87753	£3,991.45
3	£8,758.79	0.82205	£7,200.13
4	£11,958.80	0.77007	£9,209.08
5	£12,174.52	0.72137	£8,782.38
6	£12,174.52	0.67576	£8,227.06
7	£12,174.52	0.63303	£7,706.84
8	£12,174.52	0.59300	£7,219.53
9	£12,174.52	0.55551	£6,763.02
10	£12,174.52	0.52038	£6,335.38
11	£12,174.52	0.48748	£5,934.79
12	£12,174.52	0.45665	£5,559.52
Total	£124,870.22	8.04960	£78,997.57

Annex C Template of non-contestable costs

For work carried out by the water company when a developer or SLO lays the water mains and service pipes

This table lists the costs for the work that the water company will insist on carrying out and the quotations for relevant deficit and commuted sum charges and payment for asset.

Site:.....

Date:.....

Item No	Description of tasks	Details	Costs
	Onsite works		
a)	Approval of designs of on-site works produced by the developer/SLO		
b)	Diversions ³⁷		
c)	Wayleaves or easements		
d)	Inspection and supervision of contestable work		
e)	Connection to water company's existing network		
f)	Water sampling and quality analysis		
g)	Supplying and installing water meter		
	Off-site works		
h)	Design of off site-works		
i)	Off-site diversions		
j)	Wayleaves or easements		
k)	Inspection and supervision of contestable work		
l)	Connection to water company's existing network		
m)	Water sampling and quality analysis		

Charges quotations

Item no	Payment	Amount
n)	Charge for network reinforcement	
o)	Infrastructure charges	
p)	Estimated statutory commuted sum charge	
q)	Estimated payment for asset	

³⁷ Our guidance on 'Competition in providing new mains and service pipes' states that companies should allow SLOs to carry out the new part of diversions to new development sites where SLOs have the necessary permissions, and no existing customers will be affected and/or there are no engineering reasons why this work should be non-contestable.

Annex D Contestable and non-contestable work

Contestable work

- Installing on-site mains.
- Installing off-site mains in third party land and highways where SLOs have obtained the necessary easements, street authority approvals and satisfied any other legal requirements.
- Installing extensions and the new part of diversions to new development sites, where SLOs have the necessary permissions and no existing customers will be affected and/or there are no engineering reasons why this work should be non-contestable.
- Designing on-site water systems in accordance with water companies' specifications.
- Installing service pipes to water company specifications.
- Connecting service pipes to new mains (after the water company has filled the new mains with water), provided the appropriate standards are met and there are no risks to existing customers. See also the guidance on timing of service pipe connections.
- Swabbing, pressure testing and disinfecting new mains, under supervision.

Non-contestable work

- Off-site work to reinforce the existing network.
- Approving on-site water system designs.
- Designing off-site water systems.
- Installing water meters.
- Determining the timing of service pipe connections to new mains.
- Connections that involve risks to existing customers.
- Connecting new mains to existing mains.
- Connecting service pipes directly to existing mains.
- Water sampling and quality testing.

Annex E Regulatory impact assessment

1. Purpose

The Water Act 2003 (WA03) amends the Water Industry Act 1991 (WIA91) and creates a new regime for calculating payments and charges for installing new infrastructure and handling disputes about the terms and conditions of self-lay and requisitioning agreements. The relevant provisions come into effect on 28 May 2004.

In December 2003, we issued two consultation papers outlining the self-lay and requisitioning provisions of the WA03 and proposing a framework for implementing these. The consultation papers were 'Financial arrangements for self-lay and requisitioning agreements' (the financial consultation) and 'Process for handling disputes and appeals' (the disputes consultation). Our consultations included the draft regulatory impact assessment (RIA) which covered how the industry will be affected by implementing the new framework outlined in the guidance documents. We asked stakeholders to comment on our view of the impact of our guidance on the industry.

We have now considered the responses to the draft RIA. On the basis of the responses to the draft RIA, we have not changed our assessment of the impact on the industry in the final RIA or the approach that we set out in our guidance documents.

1.1 Proposals in the draft RIA

In the draft RIA, we set out three options for implementing the new regime.

1. Do nothing. There is no statutory requirement for us to produce guidance on these issues.
2. Propose a set of principles for the industry to follow when calculating the charges and payments that will be made when works are requisitioned.
3. Prescribe the levels of the charges and payments that they should make.

We felt that the risk of following option 1 was that water and sewerage companies may miscalculate payments or implement a variety of policies which would create inconsistency across the industry. This may generate a high number of complaints and have a detrimental effect on the market for installing new infrastructure.

Option 3 leaves no flexibility for water and sewerage companies to decide their own policies and may increase the costs to Ofwat of implementing the regime. Overall, we prefer Option 2 as we consider this will enable water companies to implement the proposals in the WA03 effectively, including developing their internal policies and procedures where necessary.

1.2 Response to the draft RIA

We received over 35 responses to these consultations and around a sixth of respondents comment specifically on the draft RIA. These comments are summarised in our document 'Consultation on financial arrangements for self-lay and requisitioning agreement: Summary of responses and our conclusions'. In general, respondents felt that our estimates of the impact on the industry on the new regime were reasonable although it would be easier to judge this once the final guidance is published.

We will monitor the implementation of the legislation around the industry and review whether the RIA still applies.

Our assessment of the benefits and costs to the industry follows.

2. Benefits

The new framework will affect an average of 175,000 new connections to the water and sewerage distribution system each year. Defra estimated that the value of the relevant market is around £100 - £160 million each year.

We see the following benefits in producing the guidance documents.

2.1 Benefits to water and sewerage companies

- It enables water and sewerage companies to plan policies to implement the WA03 more effectively and to decide a business strategy in relation to the self-lay market.
- It reduces uncertainties for water and sewerage companies, by explaining when we will intervene in disputes/appeals and the information we expect from the parties to the disputes/appeals.
- It enables water and sewerage companies to reduce some costs in the long-term as they will be aware of the principles that they should follow when deciding policies, and what information we will require when we investigate disputes/appeals.
- It requires water and sewerage companies to improve the efficiency of their procedures particularly with regard to estimating costs issuing quotations and responding to disputes/appeals.

2.2 Benefits for developers and other customers

- It gives developers greater choice in the installation of new infrastructure and the ability to influence the timetable for water and sewerage companies carrying out works.

- It provides clarity enabling developers to take advantage of new opportunities in the market. It enables developers to make reasoned comparisons of the costs of requisitions and self-lay options so they can make a fully informed choice about the options available to them. This option will strengthen the market and reduce complaints. Developers will be the main beneficiaries of the new legislation but may pass savings on to house buyers.

2.3 Benefits for us

- Setting out a clear framework understood by all parties to the dispute/appeal enables us to handle cases more efficiently and should reduce the number of complaints that we receive in the longer term.
- Our approach improves the transparency of regulation.

3 Costs

The expected costs are spilt into two categories: costs that the water and sewerage companies and developers will have to finance and the expected costs for us.

3.1 Compliance cost to the industry

- There will be the ongoing costs incurred by the water and sewerage companies in implementing policies that meet the principles set out in the final guidance. However, the water and sewerage companies may have to incur costs anyway when the provisions of the WA03 come into force to ensure that they are complying with the new legislation. The principles in the final guidance enable water and sewerage companies to focus on any changes that they need to make in their policies. This will help them increase efficiency and reduce costs.
- Clarifying the financial arrangements may generate marginal additional costs for developers but any costs are likely to be outweighed by the benefits that are likely to arise from a transparent regime, including competitive charges and improved efficiency. We do expect the generality of the new or existing customer base to subsidise these marginal additional costs.
- There may be a charge to water and sewerage companies and/or complainants for handling disputes that are referred to Ofwat. However, this will partly replace the costs currently incurred in pursuing these disputes already. The industry already incurs costs in responding to developers' complaints and should not have to produce any significant new information for us to deal with disputes/appeals.

3.2 Compliance cost to Ofwat

- We incurred minimal costs for preparing the consultation paper and the final guidance, and in running a workshop in January 2004 to present key points from this consultation to the industry.

- We will incur costs in handling a new range of disputes about terms and conditions of self-lay agreements, and requisitioning disputes. There will be staffing implications for this new work. We will also incur costs in obtaining external advice. We expect our costs of dealing with disputes will reduce over time as water companies and developers take into account early determinations and refine their policies accordingly. We have estimated that the cost to us of handling disputes referred under the new regime to be £50,000 per annum. This figure will be reviewed in the light of our experience in handling disputes/appeals. We intend to recover some or all of our costs incurred in dealing with disputes/appeals from water companies and developers.

4 Monitoring and review

We will review the RIA when we next review the financial guidance, which will be in 2006. The SLG is considering its role in monitoring the implementation of the legislation around the country.