

Charging for new connections – a discussion paper

About this document

This document discusses the existing framework for charging for new connections, and its associated criticisms. New legislation set out in the Water Bill 2013 will allow Ofwat to produce charging rules that could address these issues, and we will consult on these rules in due course. This discussion paper requests views from interested stakeholders on whether we have identified correctly all of the key issues to be addressed through rules, and what these rules should include.

Throughout this document, we use the term **‘developer’** to refer to any business or individual whose new buildings or premises require water or drainage services.

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Executive summary

The Water Industry Act 1991 (WIA91) allows water and sewerage and water only companies ('water companies') in England and Wales to provide the infrastructure needed to connect a new development site to a water supply and/or provide drainage.

Some stakeholders have criticised the existing charging framework for new connections as lacking transparency, with charges not always reflecting properly the costs involved. Other criticisms include:

- an inconsistent basis for charging between water companies;
- potential cross-subsidies; and
- double charging.

New legislation set out in the Water Bill 2013 ('the Water Bill') will allow Ofwat to produce charging rules that could address these issues. In setting these rules, we will have regard to any guidance issued by the Secretary of State for Environment, Food and Rural Affairs, and Welsh Ministers. The legislation will also allow for Ofwat to produce charging rules for a number of other areas – such as for water companies' charges schemes, and for access pricing. These areas are outside the scope of this discussion paper.

This document describes the current charging framework for new connections, and discusses some of the factors we could consider in the context of setting new charging rules. It does not constitute the formal consultation required by the Water Bill – we will do this in due course. In the meantime, we welcome any views from stakeholders on the issues we have raised in this document – in particular:

- whether you consider that we have captured appropriately all the key issues with the current charging framework; and
- whether you have any views on what rules a future charging framework for new connections should include.

We are also going to establish a **charging for new connections working group**. If you are interested in joining this group, please contact us using the email or postal addresses included in chapter 6.

1. The Water Bill and other interdependencies

In its current draft form, the Water Bill allows for the detailed charging arrangements to be removed from the WIA91. These would be replaced with a power for Ofwat to issue charging rules for new connections to water and sewerage infrastructure. This would create a new charging framework – that we would develop and consult on – with which the companies would be obliged to comply. These rules would need to be written with regard to any guidance produced by the Secretary of State and Welsh Ministers.

The Water Bill also gives Ofwat a power of direction, enforceable under section 18 of the WIA91, if we were to consider that a company is not acting in accordance with the rules.

Some of the key relevant clauses of the Water Bill 2013, in relation to new connections, include:

- **clause 17**, which sets out a power for Ofwat to issue rules about new connection charges related to water and sewerage infrastructure;
- **clause 18**, which makes several amendments to existing legislation to allow for charging rules under clause 17 to be the basis on which charges for new connections to a water supply system are made; and
- **clause 19**, which makes several amendments to existing legislation to allow for charging rules under clause 17 to be the basis on which charges for new connections to a company's sewerage system are made.

2. Policy context

Any statutory guidance issued by the UK Government and Welsh Ministers will clarify further the policy context for our decisions on charging rules. In setting out the considerations in this document, we have taken into account a range of policy objectives, reflected in the documents currently available from Defra and Welsh Ministers (including the UK Government's charging principles).

In its impact assessment (IA), Defra stated that it wishes to provide for a new charging framework that will:

- be cost reflective;
- make possible the efficient use of resources and effective competition;
- reduce the administrative burdens associated with how the current system operates (particularly the complex calculations for requisition charging);
- be consistent with how the supplier discharges its relevant duties and obligations;
- reduce significantly the level of complaints and disputes over charges; and
- be more flexible to change, particularly in the light of market reform.

3. The existing framework

The WIA91 allows water companies to charge developers to provide relevant infrastructure and connect new developments to the water and sewerage network. These charges are intended to reflect the costs of the infrastructure that is needed to make such connections. There are different ways in which infrastructure can be provided – and there are also different charges that apply depending on how the relevant infrastructure is provided. The charges that are relevant to the new connections framework (as shown in the diagram in appendix 1) are as follows.

- **Connection charges.** The developer pays these charges to the water company when premises are first connected to the water main or to a sewer. This charge is intended to cover the costs of the physical connection to the main or sewer.
- **Infrastructure charges.** The developer pays these charges to the water company when premises are first connected to the water main or to a sewer. This charge is meant to reflect the developer's contribution towards the costs of developing local networks to serve new customers.
- **Requisition charges.** The developer pays these charges to the water company when the former requests the latter to build the necessary infrastructure required as a result of the new connection. These charges can also cover network reinforcement. The calculation for the requisition charge is set out in the WIA91.
- **Self-lay charges.** The developer pays these charges to the water company for the costs of network reinforcement that the company carries out. These charges can also include administration costs and design fees. If a developer chooses the self-lay option (as opposed to requesting a water company to build the necessary infrastructure and paying a requisition charge as above), then it can build the necessary infrastructure itself or contract with a third party – such as a self-lay operator (SLO) – to build it. The developer pays the costs of building these assets to the SLO, not the water company. But it pays the water company self-lay charges for costs that the company incurs in accommodating the SLO's activities.

- **Asset payments.** The water company makes these payments to a developer once it has adopted the assets owned by the developer (for example, those put in place by an SLO as discussed under ‘self-lay charges’ above). Where assets are provided by an SLO and later adopted by the water company, it makes an asset payment. This currently only applies to water supply assets.

Table 1 below summarises the different arrangements that exist.

Table 1 Charges by infrastructure provision

Ways in which infrastructure can be provided	Relevant charges
Requisitions for water mains and public sewers	Requisition charge Infrastructure charge
Self-lay of water mains	Self-lay charge Infrastructure charge Asset payment
Self-lay of public sewers	Infrastructure charge
Service connections	Connection charge Infrastructure charge

Owners or occupiers of premises, including developers, can choose between the following options when they require connections for new developments.

- Requisitions.
- Self-lay.

We discuss each of these in more detail below.

3.1 Requisitions

Under this arrangement, the developer requests the water company to build the necessary infrastructure. The water company then builds the infrastructure required to connect the new development to its network. Requisition charges are intended to recover the costs incurred in providing assets to serve the new development where those costs exceed income received for the development over 12 years.

Requisition charges are site specific and can also include the cost of network reinforcement if work is required to provide additional infrastructure as a result of the demands of the new development. Many developments and connections to individual premises will not require a requisition, and in those cases will be subject only to connection and infrastructure charges (see above).

Appendix 2 contains an illustrative example of a requisition.

3.2 Self-lay

This option requires the developer to either:

- build the necessary infrastructure itself; or
- contract with a third party – such as an SLO – to build it.

The developer pays the SLO the up-front costs of building these self-lay assets, and pays the water company for any additional infrastructure required (which legislation states that only the water company can build). The water company then ‘adopts’ these assets, and pays the developer an asset payment when it takes ownership. As discussed above, the water company makes an asset payment where assets are provided by a developer or SLO and later adopted by it.

Appendix 3 makes a comparison between a developer requisitioning the infrastructure from the water company and an SLO providing the relevant infrastructure.

4. Criticisms of the current charging framework

Both the [independent review of competition and innovation in water markets](#) (the 'Cave review') and the [review of Ofwat and consumer representation in the water sector](#) (the 'Gray review') criticised the current charging framework for new connections. The main concerns highlighted included:

- a lack of transparency in the charging system;
- inconsistency of the basis of charges between water companies;
- potential cross-subsidies between new and existing customers; and
- double charging.

The setting of the current framework in primary legislation was also recognised as being inflexible and not fit for purpose. The Cave review recommended updating the system of developer and water company charges and payments so that developers, new appointees and water companies pay appropriate shares for connection to the network.

Currently, there appears to be:

- inconsistency between the rules for water and sewerage; and
- a lack of clarity between connection charges, infrastructure charges and requisition charges, and difficulty in understanding how they fit together.

For example, while the water companies pay asset payments once the self-laid water supply assets have been adopted, there is no equivalent asset payment for self-laid sewerage assets.

The present charging arrangements for new connections create significant costs for all parties involved in providing such services. For example, the lack of transparency in the current system means that developers can face unknown costs, which can impact significantly on their ability to build new developments. Also, in order to navigate the current charging framework, the water companies face a range of costs before they are able to generate an offer that a developer can consider.

So, over the years, various stakeholders – including customers, developers, SLOs, the water companies and new appointees – have highlighted that there are significant problems with the current charging framework for new connections. There is a broad consensus that the present provisions do not provide an effective system of charging. Any changes to the current arrangements are likely to affect these stakeholders.

For the purposes of this document, we have considered the following criticisms of the charging framework.

4.1 Considerable administrative burden

The legislation has been interpreted in different ways, which means that water companies have not always set charges on a consistent basis. This has led to disputes – generally between developers and water companies – which have been referred to Ofwat to resolve. As a result, there are considerable administrative burdens for developers, for water companies, and for us.

Estimating and recalculating charges can also impose a significant administrative burden, and can cause developers administration costs, delay and uncertainty.

According to Defra's IA, there are consultants that provide developers with technical and development services. They claim to have helped developers secure reductions or refunds of about £5.5 million of infrastructure charges that water companies have claimed in respect of developing certain sites.

The IA also observed that the current procedure for Ofwat to make determinations of disputes that are referred to it, provided for under the WIA91, is complicated and time-consuming.

4.2 Risk of double charging and lack of clarity

Infrastructure charges are often imposed in addition to requisition payments. While developers perceive an overlap between requisition contributions and infrastructure charges, water companies argue that both charges are needed to contribute to the relevant costs concerned.

While current legislation allows both charges to be applied, their role (or indeed their existence) could be clarified in a new charging framework, which could also put in place measures to avoid the risk of double charging.

4.3 Unclear incentives to self-lay

If a developer chooses the self-lay option and ownership of the assets transfers from the developer to the water company, the water company pays an asset payment that reflects the costs it would have faced had it built the asset itself. It is unclear whether or not the asset payment fully compensates developers for the relevant costs.

The issue of whether the choice for developers is tilted towards the requisition option under the existing sector arrangements needs to be examined further, especially in relation to additional administrative charges with reference to SLOs. This will help us understand whether the charging arrangements for the self-lay framework are consistent, where applicable, with the requisitions framework. There are concerns that existing arrangements may distort effective competition in markets involving SLOs, as there are perceived to be limited incentives for developers to choose the self-lay option under existing arrangements.

4.4 Potential harm to competition

Contestable services are activities that are not reserved for the water companies. There is a potential impact on competition for providing services at new developments because the arrangements make no distinction between costs that arise in relation to contestable and non-contestable services. Also, discrimination issues arise as there is no clear basis for the recovery of the respective costs attributable to each of these services.

A level playing field in the market for providing new connections to water and sewerage infrastructure is important for effective competition in this market. Central to this, in the context of new developments, is the importance of clarity over which costs and charges should be associated with providing contestable versus non-contestable services. This follows from the fact that, while contestable services can be provided by competitors of the incumbent company, in order to provide these services competitors are likely to need to secure non-contestable services from the incumbent company (that is, they also have to be a customer of the vertically integrated incumbent company).

To bring about more effective competition that promotes efficiency and economy, the charging arrangements will need to provide appropriate incentives for market participants. We have already reflected this distinction in our decisions for future price limits, and the vertically integrated companies' regulatory financial reporting will also need to reflect the associated level of accounting separation from 2015.

4.5 Difficulties with concurrent and pre-development sites

When several sites are developed at the same time by different developers that need to share the same main(s) or reinforcement, there is no clear mechanism to deal with the allocation of costs between different sites. Also, there is no clear mechanism to deal with requisitions to the boundary of a large site that will later be sold in plots to different developers, but where no actual development is yet planned.

There may also be a ‘first mover’ issue with developers that requisition water and sewerage infrastructure. As developers contribute towards network reinforcement, the development that triggers a significant incremental increase in network resilience/capacity may be subject to substantial costs, while developments taking place immediately after the increase in capacity may be subject to much lower costs. This may be acceptable from a cost reflectivity perspective; but such a framework may have some degree of unintended consequences, and contribute to potentially perverse incentives (for example, to delay work to avoid ‘first mover’ costs).

4.6 Arbitrary calculations and issues relating to estimated revenue

Under a requisition arrangement, the water company builds the infrastructure to connect the new development to its network. In this context, the developer can choose to make an up-front payment known as a ‘discounted aggregate deficit’ or the ‘statutory commuted sum’. This is calculated by taking the relevant deficit charge¹ for each year and converting it into a single up-front sum.

But calculating this up-front payment relies on estimates of what the end cost of the infrastructure will be in addition to projections of revenue from customers’ water bills over a 12-year period. The estimated revenue required for this calculation is derived from the expected rate of construction, which is difficult to assess and may then vary significantly. This is because:

- phases often change during construction;
- plots may be sold to different developers; or
- the site may be presented initially as a single phase but then developed in several phases.

¹ These are annual payments made over 12 years to appointed water companies for requisitioning new domestic mains and sewers under the WIA91.

There is little economic justification for using 12 years as the chosen period.

There may also be issues with security payments that developers make to water companies – namely, whether the payments are always appropriate in their magnitude and application.

4.7 Weak locational signals

Another feature of the current charging framework is that it may give developers weak locational cost signals. For example, developers do not always incur the full costs of connecting to the network. Instead, their charges could depend on the speed with which new developments are filled.

So, if occupancy rates of new developments are high, resulting in high levels of revenue from end customers in these areas, developers could pay very low requisition (or self-lay) charges.

This is because the revenue from customers would quickly exceed the annual payments calculated, meaning that the developer stops paying requisition (or self-lay) charges. So, charges could reflect only a small proportion of the total cost of connecting the development in some cases.

Having the developer totally shielded from the cost of connection, because of these netting off arrangements, may result in price signals not being sent on where best to locate developments. For example, if a developer had a choice to locate in two broadly equivalent sites, but with one site being significantly more expensive to connect to the water network, it could be desirable for the developer to have some incentive to favour the low-cost site versus another in its location decision, rather than have these signals blunted by other customer revenues.

4.8 Rigidity and limitations of primary legislation

As the current charging framework is enshrined within primary legislation, this sometimes means that it is not always able to adapt to market or cost changes to ensure appropriate or fully cost-reflective arrangements. This can result in over- or under charging for services or assets provided. It also results in a lack of clarity, transparency and consistency. But these problems are not related solely to inflexibilities in primary legislation.

The obligations and restrictions that water companies face also stem from the licence conditions imposed on them. Developers have claimed that there is ambiguity about the scope to recover payments in relation to the powers in the primary legislation – specified within sections 42 and 146 of the WIA91 – and the provisions for infrastructure charges specified within the licence conditions and the associated Ofwat guidance letters.

5. What could charging rules include?

Given the existing policy context, we envisage that a future charging framework should be ‘user friendly’ and transparent to all parties. It could include:

- a simpler, more consistent framework that enables quick and easy agreements to be made, avoids challenges and referrals, and makes the market for providing new connections more transparent;
- greater cost reflectivity to ensure a balance of cost recovery from those giving rise to costs as a result of their decisions – in particular, a suitable balance between developers, customers, and water companies; and
- increased flexibility to adapt to market and cost changes, as the specifics of the framework will no longer be set by primary legislation.

In creating a new charging framework and simplifying the arrangements for all concerned, we will consider whether it might be helpful to remove certain charges completely because of the perceived overlap with other charges.

There are a range of factors that we need to take into account when developing a new charging framework, including:

- how charges should be structured to provide efficient price signals and appropriate transparency to all parties;
- who pays – that is, if payments for requisitions are calculated by offsetting costs against some measure of the revenue expected to be raised from the supply of water and wastewater services to the new premises, what revenues should be used in this calculation (for example, over how many years should forecasts of revenues from future end customers relate to)? And whether the water company should even make a payment to the party requesting new water mains or sewers in cases where the costs of the new infrastructure is very low compared with the revenues expected to be collected from customers connected to that main or sewer; and
- whether, and if so where, the benefits from standardisation would offset potential losses in cost reflectivity.

We will assess these factors further as we develop and consult on the rules relating to the charging framework, having regard to relevant guidance as envisaged in the current draft of the Water Bill. Rules will need to balance all the relative factors.

6. Next steps

We will consult in detail on potential approaches to setting charging rules for new connections once the UK Government has produced its charging guidance. In the meantime, we welcome views from stakeholders on any of the issues we have raised in this document.

We recognise that there is a need for the new charging framework to be adaptable to enable change in the light of review and market reform and are interested in hearing your views.

In particular, as we said at the start of this document, we welcome views on:

- whether you consider that we have captured appropriately all the key issues with the current charging framework; and
- whether you have any views on what rules a future charging framework for new connections should include.

Please email your responses to tom.rogers@ofwat.gsi.gov.uk or post them to:

Markets and Economics Division
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Centre City Tower
7 Hill Street
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We are also going to establish a **charging for new connections working group**. If you are interested in joining this group, please contact us using the above email or postal addresses.

7. Further information

[The Water Industry Act 1991](#), the UK Government, 1991.

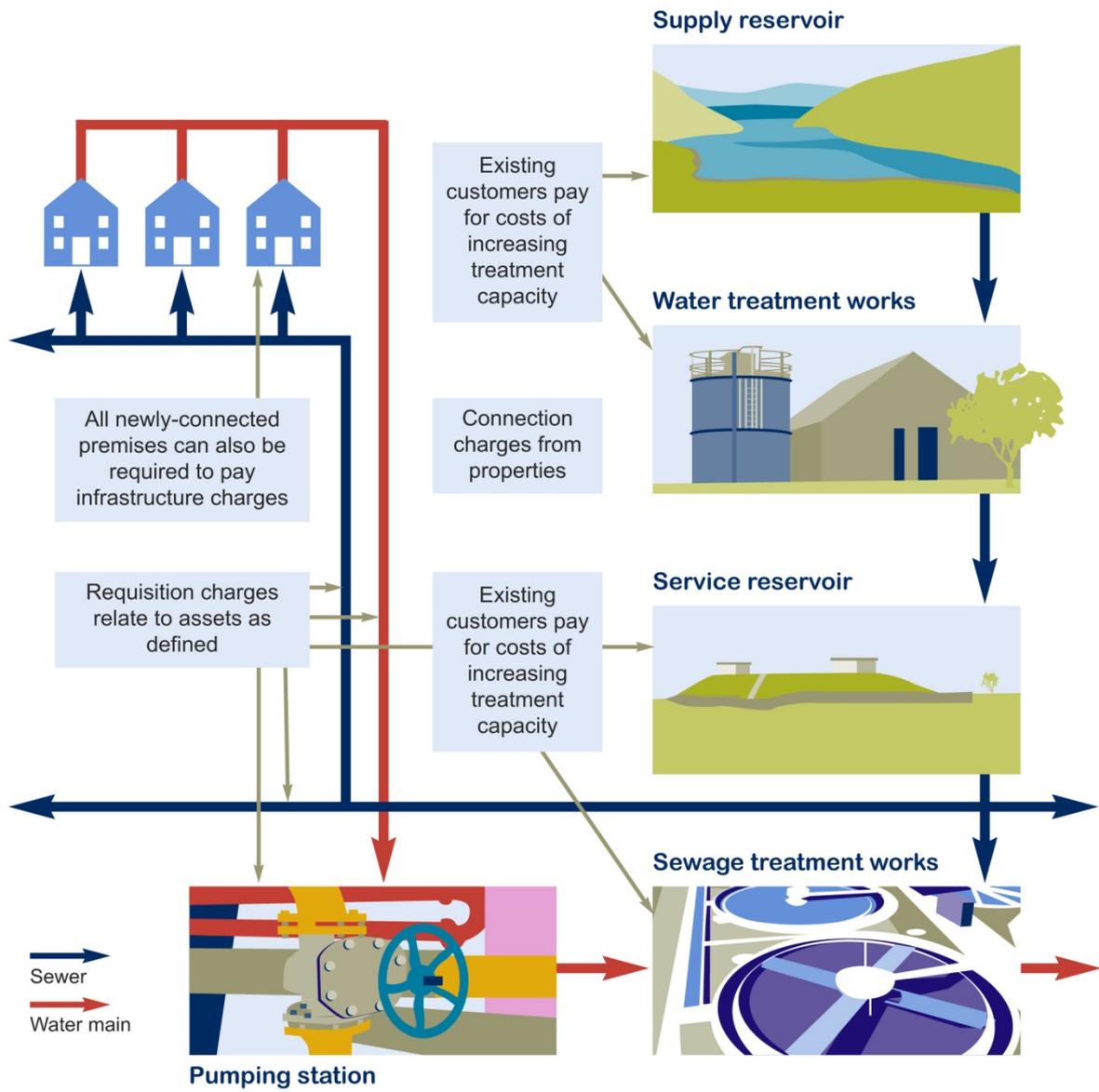
[‘Independent Review of Competition and Innovation in Water Markets’](#), Martin Cave, April 2009.

[‘Review of Ofwat and consumer representation in the water sector’](#), David Gray, 2011.

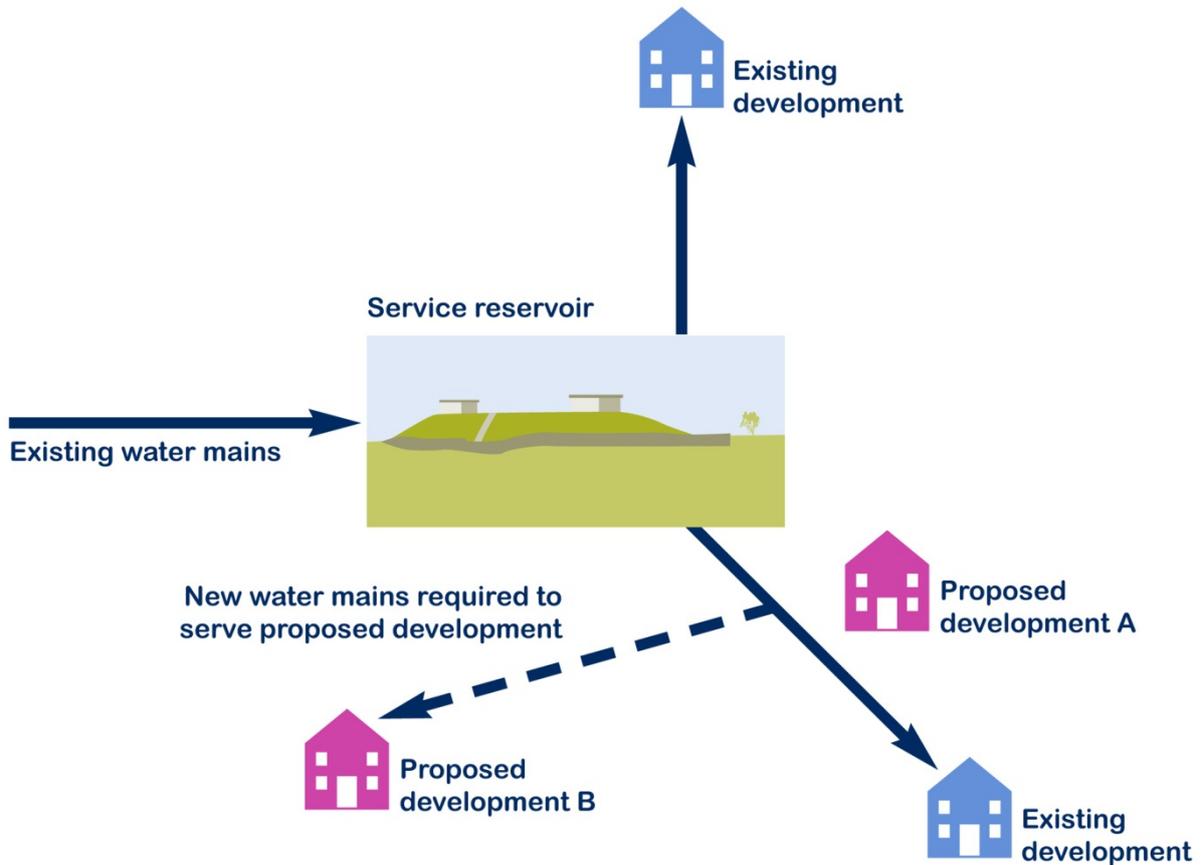
[Defra Impact Assessment](#), Department for Environment, Food and Rural Affairs, 2012.

[Water Bill 2013 and related documents](#), UK Government, 2013.

Appendix 1: Overview of water and wastewater charges



Appendix 2: Water requisition charging



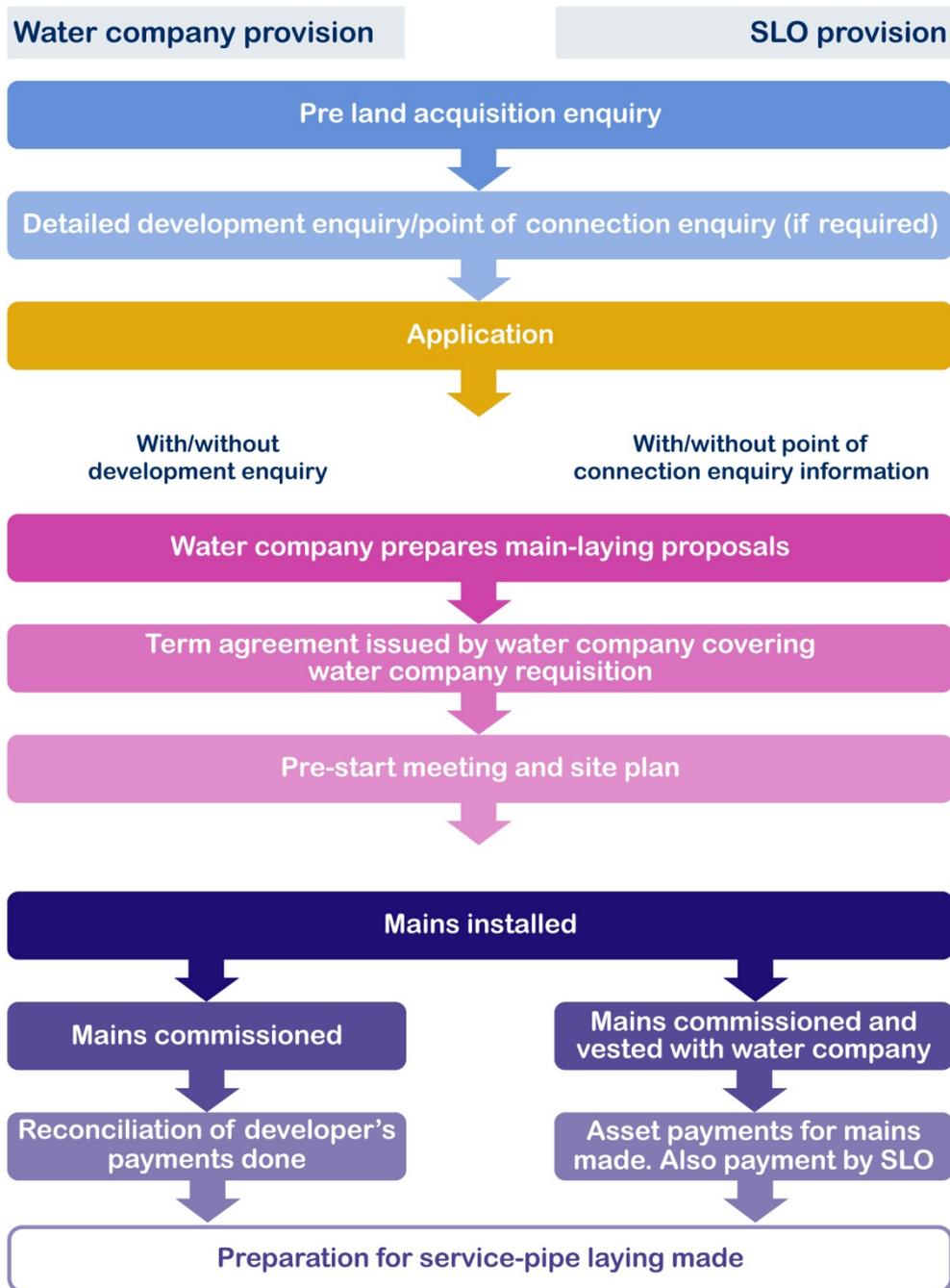
Note: Proposed development A has an existing water main adjacent to the site, so no requisition of water mains, pumping stations or service reservoirs would be required unless reinforcement work was necessary to maintain the required level of service to the existing developments.

Proposed development B has no existing public water main so requisition of the water mains (shown as a broken line), pumping stations or service reservoirs would be required to provide the water supply infrastructure to serve the site (and for any reinforcement work necessary to maintain the required level of service to the existing developments).

Appendix 3: Comparison between water company and SLO provision

Water mains requisition S41-44 WIA91

Diagram: Process stages





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