

**Independent review of section 45
administration fee and overhead costs on
behalf of the Water Services Regulation
Authority (Ofwat) – summary**

About this document

In 2013 we commissioned a consultant to carry out an independent review of the overheads and administration fees that water companies charge when undertaking a new connection under section 45 (water supply connections) of the Water Industry Act 1991. This document is Ofwat's summary of the findings of that review.

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Executive summary

Ofwat (the Water Services Regulation Authority) is responsible for determining disputes in relation to connections provided under section 45 of the Water Industry Act (**WIA91**) and under section 45(6) a water company is entitled to recover expenses reasonably incurred when making the connection.

To inform determinations under section 45 we have been using a standard average cost of £80 to cover administration fees and overheads for a single new connection. This was supplemented by £25 for subsequent new connections on the same site. But we have used these figures since 1998 and the purpose of this review was to update those costs in the light of changes to companies' overhead costs.

In 2010, we commissioned Hyder to carry out a comparative study (the '[Hyder report](#)') into the cost of new water supply connections work. The recommendations from this review into overheads and administration costs will complement the Hyder report, allowing us to comment on all elements of the charges made by a water company for new domestic water supply connections.

This review has been based upon the responses of ten water companies to questionnaires seeking information regarding the charges made for new connections and the companies' assessments of the overheads and administration costs. The main conclusions are set out below. The overheads and administration costs associated with the provision of a new connection have been separated into two categories, as follows.

- A. Those charges that companies incur in providing a specific new connection – these have been defined as **direct on-costs**.
- B. Those charges that seek to recover the high-level costs of operating a water company but are not attributable to a specific job – these have been defined as **company on-costs**.

The review team developed a process model and assessed the cost of each administrative task required to provide a new connection. The review found that the overall cost of the non-construction activities is **£105.30** and this constitutes all the direct on-costs associated with the provision of a new connection. Based upon this model an application fee – covering the work required to issue a quotation – of **£72.14** is proposed. This is included in the overall direct on-cost.

Where there are second and subsequent connections made under the same application, the review recommended that their application fee should be reduced to £43.75 and their full administration costs to £64.29, reflecting the likely cost savings of not duplicating technical tasks.

All the activities included in the preparation of the quotation are essential to the process of providing a new supply and the review therefore considered these to be costs that the companies may recover based upon the definition in section 45(6) of the WIA91.

Methodology

The aim of the review was to establish the overheads and administration fees that companies charge when undertaking a new connection – and to set a benchmark for what would constitute a reasonable charge. This information, alongside the results of the Hyder report, will inform our analysis when making a determination with respect to the disputed cost of a new connection, taking into account the reasonable construction costs incurred and the additional costs that the water company incurs in the management of that process.

The review team identified three key elements that would assist in delivering the review's aim.

1. The review team developed a general process model to compare with the activities undertaken by all the water companies in the provision of a new connection. The participating companies supplied this information in the review's stage 1 questionnaire.
2. The collection of data was based upon four worked examples that refer to the delivery and costing of simple, typical new connections. The review team analysed the detailed responses required as part of the stage 2 questionnaire to identify the actual overhead and administration fees charged after construction costs were stripped out.
3. In the stage 3 questionnaire, the companies provided the financial models that they use to support the recovery of overheads and administration costs. The review team compared this information with the activities and the costs of those activities identified within the process model to identify any other areas of cost recovery and comment upon the scale of the costs recovered and their applicability to the section 45 process.

Ten water companies participated in the review. Their selection sought to reflect the following.

- Broadly equal representation of water and sewerage companies (WaSCs) and water only companies (WoCs).

- Geographical balance across England and Wales.
- Companies with a history of receiving large numbers of customer complaints on connection costs (weighted by the overall number of connections made each year).
- Companies with a history of receiving no, or few, customer complaints on connection costs (again weighted by the overall number of connections made each year).

Analysis of responses

This section reviews the responses received from the companies to identify the on-costs that the companies seek to recover. This is to consider if there are any charges that a company may make in addition to construction costs when making a new connection under section 45 of the WIA91.

The use of terms such as overheads, administration fees and on-costs is open to various interpretations and this can lead to confusion. The independent review attempted to remove ambiguity and simplify the terms used. Any costs associated with tasks other than the actual physical installation of a new supply are referred to as on-costs and these are defined below.

Company on-costs

The data the companies provided shows that, in general, they seek to recover:

- the costs associated with the construction works and the necessary administration and technical works associated with the new connection, that is, **direct on-costs**; and
- an additional payment that contributes to the cost of operating the company. This category has been defined as **company on-costs**.

Six of the companies' responses explicitly referred to the recovery of company on-costs, and five of those companies apply a percentage uplift to construction costs and direct on-costs. Two companies do not seek to recover company on-costs and the remaining two companies' responses were silent on this issue.

In their responses, the companies stated that the areas of the business to which company on-costs contribute are information services, customer contact, human resources, procurement, finance, insurance, legal services and facilities management. The on-cost attributed to a new supply to cover these company overheads varied between 7.5% and 23.8%.

The company on-costs cover high-level company costs but the calculation of those charges and the resultant scale of charges vary from company to company. In some cases, the financial models that the companies provided showed the high-level costs of operating the company and the proportion attributed to each part of the company. Most submissions did not provide this level of detail and the wide range of the percentage uplifts that companies apply suggests that the method of deciding upon the company on-costs varies from company to company.

As part of their responses to the worked examples, the companies provided data from which the review team assessed their direct on-costs and company on-costs. These figures illustrated the method of recovering on-costs and the average rate of recovery. Most of the companies use a percentage uplift as part of this process. The use of a percentage uplift to another cost or group of costs means that the actual recovery depends entirely on the specific job.

In assessing whether or not a charge is reasonable the review team first looked at whether a charge is actually permitted. Section 45(6) of the WIA91 states:

“Where a water undertaker carries out any works which it is its duty under this section to carry out at another person’s expense, the undertaker shall be entitled to recover from that person an amount equal to the expenses reasonably incurred by the undertaker in carrying out the works.”

The review team considered that the company is entitled to recover expenses reasonably incurred in the provision of the new supply but that there are no expenses that might be referred to as company on-costs incurred in the provision of that supply. The company would have experienced those high-level costs whether or not the new connection had been requested and therefore they cannot be directly attributed to that new connection.

The review concluded that company on-costs with respect to the provision of a new household supply under section 45 of the WIA91 are not recoverable as part of the expenses reasonably incurred by the appointed company under section 45. This is a legal and policy decision that Ofwat must consider in considering disputes.

Direct on-costs

The data the companies provided shows that the activities they carry out in providing a new connection are largely common across all of the participants. Where those activities directly relate to providing a specific connection, then the costs associated will be the construction costs and the direct on-costs that the company may recover as the reasonable expenses incurred in the provision of the service. These direct on-costs are the administrative and technical activities that directly relate to the provision of new supplies.

This section sets out a model containing all of the principal administration activities in the provision of a new supply.

General process model

For this study the review team developed a simple process model setting out all of the principal tasks in the provision of a new supply. Table 1 shows the principal steps in the process. The review team analysed the submissions made by the participating companies to confirm the applicability of the model and confirmed that most companies carry out most of the tasks listed.

Table 1 Principal tasks associated with the provision of a new connection

Step	Task
1	Issue application form
2	Review application form
3	Undertake network study
4	Site survey
5	Design
6	Issue quotation
7	Receive payment
8	Schedule installation
9	Issue works order to contractor
10	Raise relevant requests or notices
11	Water regulations check

Step	Task
12	Install connection
13	Create account
14	Update records
15	Quality audit

The first six tasks listed in table 1 constitute the work required to issue a quotation. These form an essential element of the overall process if the construction phase is to proceed smoothly and the charge to the customer is to be accurate. Under these circumstances the review team considered that the site survey and subsequent design are a key part of the process and that an application fee (comprising these six tasks) is therefore an expense reasonably incurred by the company whether or not the connection then proceeds. Tasks 4, 5 and 11 (highlighted in bold and pink shading) are technical rather than administrative tasks. Tasks 3, 10 and 12 (highlighted in bold) are site-specific and/or construction tasks, the costs of which will be specific to the individual requests and separate from common administration costs. The review noted that a network study was not always a requirement and often only necessary for large supply requests.

Direct on-costs – observations and issues

Based on the process model in table 1, the data from companies and average staff costs, the review estimated the average time spent on each task in order to estimate the cost of each step in the process. The exercise did not include any costs relating to tasks 3, 10 or 12. These would be specific to the individual supply request and additional to any average administration costs.

The resulting modelled direct on-cost is £105.30 for the full process and £72.14 for the application stage process (tasks 1 to 6). The modelled costs are within $\pm 10\%$ of the declared average costs of the participating companies and as such the review team considered that this model is suitable for Ofwat to use to inform our determinations.

The process model shows that the administrative tasks included in the new connections process are independent of the scale or cost of the work and the direct on-cost recovery should be based upon a flat rate fee for each connection.

When the same developer makes two or more applications for the same site the review considered that the cost of the second and subsequent applications should attract a lower fee. Administrative tasks will be duplicated and there will be no cost saving. The saving that might be offered for technical tasks is a reduction in the cost of the site visits – as the companies can take the opportunity to carry out two or more inspections at the same time – and a simplification of the design process. To account for these reductions in time and effort on the part of the water company, it was the opinion of the review team that a 50% reduction in the charge for technical tasks should be offered for the second and subsequent applications. This would result in a reduction of £28.39 for the second and subsequent applications fees (reflecting the two technical tasks in steps 1 to 6) and a further reduction of £12.62 in the remaining process. This would result in an application fee of £43.75 and a full administration fee of £64.29.

Recommendations

Based on its findings, the independent review made the following recommendations to us.

1. We should not allow company on-costs within the expenses reasonably incurred and recovered under section 45(6) of the WIA91. This is a legal and policy consideration for the regulator.
2. The acceptable overall direct on-cost for a section 45 new connection is £105.30.
3. Companies should charge an application fee of £72.14, which is included within the overall direct on-cost. This fee will cover the administrative and technical tasks associated with a single new connection requested under section 45 of the WIA91.
4. The application fee should be non-refundable if the customer decides not to continue with the application.
5. When a developer requests two or more connections at the same location the application fee for the second and subsequent connections should be reduced to £43.75 and the full direct on-costs to £64.29 to reflect the savings that may be attributed to reduced travel time and costs.
6. All charges defined as direct on-costs should be reviewed annually and adjusted in line with the consumer price index (CPI).



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