

## Water and Sewerage Infrastructure Charges and Requisitioning in the Water Industry

### Introduction

This paper considers infrastructure charges and requisitioning within the water industry and the relationship that exists between these two elements of charges that are used to fund the necessary improvements to infrastructure as a consequence of new development.

In understanding this important relationship, the origins of infrastructure charges have to be considered in detail as they deal with funding to provide the necessary capacity within the existing water and sewerage networks for new development. Whereas requisitioning deals with the funding to provide the new mains required to connect to the existing networks.

The relationship between infrastructure charges and requisitioning should be clear and unambiguous because it affects how the impact of new development is funded and the costs paid by developers affects the development value of land.

The boundary between infrastructure charges and requisitioning charges is not universally understood and this is demonstrated by the different approaches taken by water companies and in particular how offsite improvements that are required because of new development are funded/charged. Most recently some water companies have been including the full cost of offsite works within the requisition costs, totally ignoring the funding they receive from infrastructure charges. This is double counting.

### Section 37 Duty (S94 for sewers)

The Water Industry Act places a statutory duty on all water undertakers to develop and maintain an efficient and economical system of water supply within its area and to ensure that all such arrangements have been made:

- (a) for providing supplies of water to premises in that area and for making such supplies available to persons who demand them; and
- (b) for maintaining, improving and extending the water undertaker's water mains and other pipes, as are necessary for securing that the undertaker is and continues to be able to meet its obligations under this Part.

In order to carry out these duties properly, water (and sewerage) companies must plan ahead to meet demand from new customers. This requires being actively involved in the planning process, understanding the capacity issues within their networks and reacting accordingly if additional demand is placed on the networks.

### The Water Act 1989 and how Infrastructure Charges were introduced

The Water Act 1989 privatised the ten public water authorities creating ten regional water companies in their place and also created OFWAT. It was recognised that new development places additional load on the existing water and sewerage networks. It was recognised that there was a need to fund not only the costs associated with connecting to the existing networks, but also the provision of additional capacity within the existing infrastructure.

A letter was sent to the Managing Directors of each of the Statutory water companies on 7<sup>th</sup> July 1989 setting out the basis for setting the limit on infrastructure charges in licence condition C. Section 79(2) of the Water Act permitted Infrastructure Charges to be made. The intention was to estimate the investment in new capacity required over a ten year period to meet additional demand for domestic water and sewerage services and the number of connections to which that related. All investment that could be covered by the requisitioning provisions was to be excluded. The level of investment taken into account for Condition C was to be excluded from the investment taken into account in setting the 'k' factor.

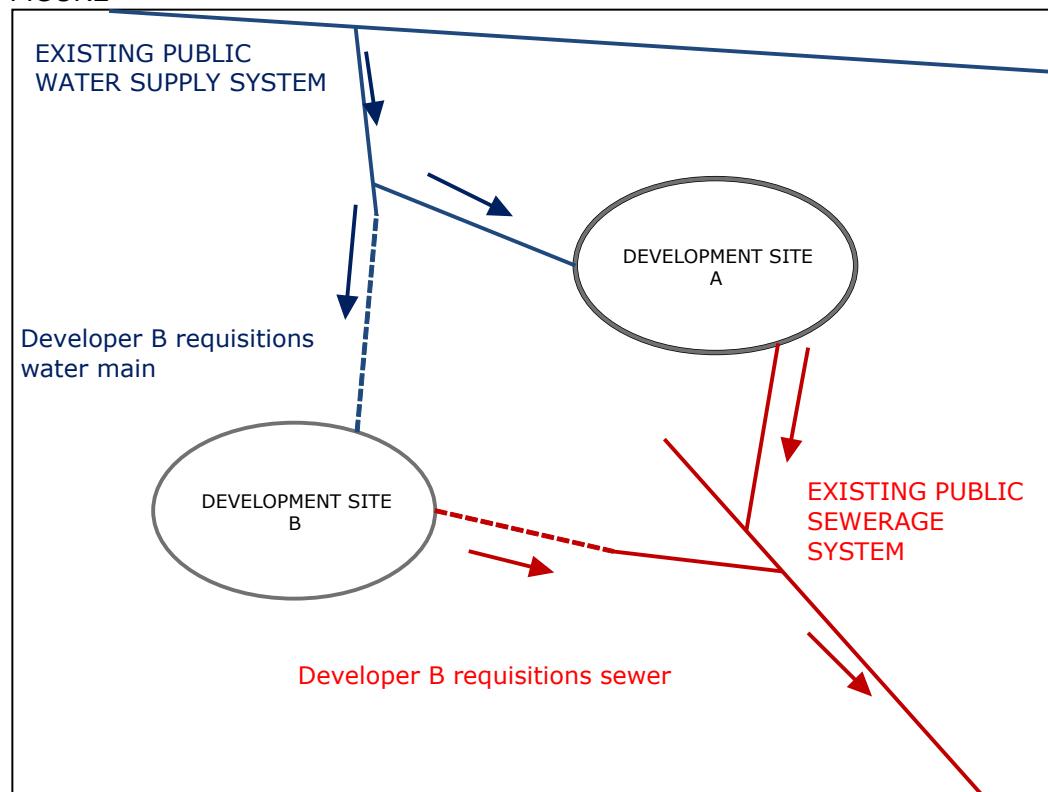
Appendix A to the letter of the 7<sup>th</sup> July 1989 gave clarification to the Infrastructure Charges regime:

A1-A3 dealt with general provisions and when charges became payable. A4-A5 made it clear that charges related to dwelling units and how conversions and extensions would be dealt with. A7 dealt with Existing Agreements (such as the Town and Country Planning Act). A8 and A9 dealt with commercial and industrial premises. A10 dealt with other charges such as new meter charges.

The most important points in Appendix A related to A11 to A14 and these are dealt with in more detail here:

- A11. Requisitioning enables developers to have water mains laid to connect their development to the undertaker's infrastructure. The infrastructure charge contributes towards the costs which have been, or will, incurred in providing the necessary capacity in the undertaker's infrastructure.
- A12. Requisitioning arrangements included from places on existing mains governed by good engineering practice.
- A13. A figure (attached below) was included to illustrate how and when requisitioning on site B would be applicable.
- A14. The arrangement is equitable in that developers pay the same water infrastructure charges in similar situations but if the sites are developed beyond the limit of the existing networks the extension of these networks is met by the developer through requisitioning.

FIGURE



Appendix B set out the basis for the calculations and required the water companies to obtain information from planning authorities to estimate the number of new dwellings that were likely to be connected to the existing systems and to estimate the total costs associated with providing capacity. The calculation of the Infrastructure Charge required the total costs for new domestic connections to be divided by the number of dwelling units.

***It was clear therefore that any additional capacity required within the existing systems was to be paid for from Infrastructure Charges.***

The assessment method resulted in a wide range of charges across the water industry as costs associated with new resources and treatment capacity had also been included. In 1995, the Director General of Ofwat sent a letter (RD2/95) to each of the regulatory directors of the water companies and the water and sewerage companies setting out a revised system for infrastructure charges, separating out the costs associated with resources and treatment, to be included in 'K', from those associated with the local distribution system. This provided greater certainty as a uniform infrastructure charge (£200) was set across the industry for both water and sewerage respectively.

The letter explicitly stated that infrastructure charges were to finance the costs of local system enhancement (i.e. the local distribution system only).

### **The Water Industry Act 1991 and The Water Act 2003**

The provisions in the 1989 Water Act concerning requisitioning and infrastructure charges were carried into the Water Industry Act 1991

- S146-charging
- S41 & S98 Requisitioning

Changes were made to the WIA1991 by the Water Act 2003 primarily associated with powers for determining disputes and introducing self lay options to developers. With the power to determine disputes being given to Ofwat there was/is a need for Ofwat to provide clear and unambiguous guidance on such matters as requisitioning and infrastructure charges.

### **Competition Commission Reports**

The Ofwat approach to infrastructure charges was scrutinised by the Competition Commission in 1995 in two reports as follows:

“A report on the determination of adjustment factors and infrastructure charges for South West Water Services Ltd”

“A report on the determination of adjustment factors and infrastructure charges for Portsmouth Water plc”

The reports dealt with the relationship between infrastructure charges and ‘K’ factor funding in the water industry and stated that the Director set a standard infrastructure charge limit of £200 (at that time) per service for all companies, using his method of calculation based upon only local development costs. The costs associated with trunk mains, treatment works and other remote works were not therefore allowed in the standard amount.

The Director contended that if remote infrastructure and non-infrastructure costs associated with increased demand were to be funded from general sources and the costs of local infrastructure development were to be funded by requisitioning charges, it could be argued that there was no need for any infrastructure charge. However, he accepted that requisitioning charges did not match the total costs of local development in all cases. The Director had, therefore, determined an infrastructure charge limit of £200 to meet the costs of local infrastructure development only. Costs associated with remote infrastructure, resources and treatment were to be funded through the supply/demand element of the K allowance.

### **Requisitioning Charges**

The costs associated with a requisition for a new water main are dealt with in Section 43 (and 98 for sewerage) of the Water Industry Act. It is important when establishing the costs that the point of connection should be in accordance with good engineering practice ( i.e. connection to pipes of the same size or larger) and the presumption of capacity in the existing system is provided by the payment of infrastructure charges.

Section 43(2) states:

*The annual borrowing costs of a loan of the amount required for the provision of a water main is the aggregate amount which would fall to be paid in any year by way of payments of interest and repayments of capital if an amount equal to so much of the costs reasonably incurred in providing that main as were not incurred in the provision of additional capacity had been borrowed, by the water undertaker providing the main  
and*

Section 43(4) states:

*For the purposes of this section the costs reasonably incurred in providing a water main (“the new main”) shall include—*

(a)the costs reasonably incurred in providing such other water mains and such tanks, service reservoirs and pumping stations as it is necessary to provide in consequence of the provision of the new main; and

(b)such proportion (if any) as is reasonable of the costs reasonably incurred in providing [or procuring the provision of] any such additional capacity in an earlier main as falls to be used in consequence of the provision of the new main.

It has been argued that the '**in consequence**' provision in the Act can be interpreted as including any improvements that may be required in the existing system beyond the point of connection . However, this argument is flawed because it ignores the premise upon which infrastructure charges are levied. Infrastructure charges were 'designed' and introduced to provide the funding required for the provision of the additional capacity required as a consequence of development. It therefore follows that these costs should **not** be included in any requisition costs. In addition, any costs associated with remote infrastructure, resources and treatment that are funded through the supply/demand element of the K allowance, should not be included in requisition costs. Any large growth schemes promoted by water companies should be financed through 'K' and not through requisitioning or infrastructure charges. This would be in accordance with the Ofwat approach adopted in 1995 and set out in RD2/95.

If the '**in consequence**' argument were extended to its fullest then there would be no need for infrastructure charges at all because all of the existing system improvements would be covered by requisitioning. This approach would be totally contrary to the intention when the charging regime for infrastructure charges was first established. When Infrastructure Charges were first introduced the HBF was extremely concerned that there could be double charging and the Director General at the time subsequently confirmed that double accounting must be avoided. The outcome of such an approach would mean that each and every requisition would require costly detailed and transparent analysis to justify any reinforcement costs within the existing networks.

### **Price Reviews within the Water and Sewerage Industry**

In the document Setting Water and Sewerage Price Limits for 2005-10 the following paragraph explained the situation regarding Infrastructure Charges:

#### *Infrastructure charges*

5.56 Limits are also set on infrastructure charges for properties where water or sewerage services are used for domestic purposes. Companies can levy these charges, along with the direct costs of making the connections, when properties are connected to water or sewerage systems for the first time. **Together with the direct costs of making the connection, these charges cover all of the costs of developing the local networks to serve new customers.** As with the 1999 review we will increase infrastructure charge limits in line with inflation.

In the 2009 final determination document Ofwat said the following:

#### *2.4 The infrastructure charge*

*At price reviews, we set infrastructure charge limits for connecting household premises to water or sewerage services for the first time. The infrastructure charge provides a contribution towards the costs of developing local networks to serve new customers. Companies can levy an infrastructure charge, as well as the direct costs of making new connections.*

*We have set an infrastructure charge limit of just over £297 for both the water and sewerage services in 2010-11. In the absence of a compelling reason for change, this is the same charge in real terms as we set at the last price review in 2004, but indexed by RPI. Charges for future years will increase in line with RPI.*

### **Recent Ofwat Determinations**

Various recent Ofwat Determinations has resulted in an interpretation of requisition charges and infrastructure charges that is significantly removed from the original intentions in the 1989/91 Acts and the guidance provided by the DOE at that time.