Consultation Response

HBF Response to the Ofwat Consultation on Charging Rules for New Connections and New Developments for English Companies from April 2020

ABOUT THE HOME BUILDERS FEDERATION

The Home Builders Federation is the representative body for home builders in England and Wales. HBF's membership of more than 300 companies contributes around 80% of the private new homes completed in England and Wales and encompasses private developers and Registered Providers. The majority of home builder members of the HBF are small and medium-sized companies.

The opportunity to respond to this latest consultation is welcomed. HBF and its members remain committed to seeing a successful outcome to the ongoing water and sewerage sector reforms, but have major concerns as to whether the proposed new rules will achieve Defra's stated objective of contributing to a reduction in house builder costs. Indeed, we believe there is a danger that additional costs imposed on SME builders in particular could threaten viability of marginal residential developments and suppress the volume or speed of housing delivery. The industry's position on these proposals remains largely unchanged from the comments made in response to the initial Ofwat Consultation in July 2017 - see attached Appendix H.

In November 2017 Ofwat published an important 'Decision Document', New Connection Charges Rules from April 2020. This had intended to crystallise the 24 or so responses to the earlier, related consultation, launched in July 2017. However, despite the majority of stakeholder responses, mostly home builders, SLPs and half of the NAVs who responded expressing significant misgivings with option 3 of Ofwat's proposals on the treatment of income off-set/asset payments, Ofwat has continued with an approach that inflates costs for the private sector and stifles investment in new housing schemes. .

This latest consultation appears to have persisted with the option 3 proposal to the commercial detriment of home builders and SLPs by significantly altering the financial balance with priority given to commercial interests of the water and sewerage sector.

We believe that persisting with the option 3 proposal in the latest consultation, significantly alters the financial balance between the parties and prioritises the commercial interests of the water and sewerage sector. This is of serious concern for HBF and our members and we do not believe that the evidential vacuum that still persists in terms of companies justifying many of their charges is being addressed by this consultation or its proposals.

> "We have serious concerns about viability and delivery for many schemes, these proposed changes could significantly compromise land acquisition and funding as a consequence of the impact on predictability, ROCE and Cashflow". (Developer A)
>
> "…… it is unclear what the infrastructure charge includes and inconsistent between water companies". (Developer B)

Whilst the objectives underpinning the consultation are laudable, the collective message from home builders, many of whom have asked for the inclusion of their verbatim comments in this response, is that

Home Builders Federation
HBF House, 27 Broadwall, London SE1 9PL
Tel: 0207 960 1600
Email: info@hbf.co.uk Website: www.hbf.co.uk
Twitter: @HomeBuildersFed

the consultation is not sufficiently prescriptive and/or directive. We also believe that several water and sewerage companies would welcome greater direction from the statutory regulator.

More generally, we seriously question whether the current proposals will satisfy the four overarching principles set by Government:

1. **Stable and predictable charges**
2. **Transparent and Customer focus charging**
3. **Fairness and affordability**
4. **Environmental protection**

Since publication of this consultation we have consulted further with our members for their views on Ofwat's proposals and the issue has been the subject of a major discussion at all our recent member meetings... We welcomed attendance by Ofwat colleagues at a HBF members' meeting in May at which many of the concerns and frustrations expressed in this submission were shared and expanded upon.

In addition, our response has been informed by the results of ongoing research work by HBF and its members, and includes water company responses to a series of related Environmental Information Regulation (EIR) requests.

As with any consultation, this has been shared with circa 200 HBF home builder members. Unsolicited views/comments as to the direction, content and impact of the consultation proposals from circa 500 key people engaged in the home building sector have therefore been canvassed.

Following disclosure of the HBF draft response, we were very much encouraged by the content of the letter distributed by the Chief Executive of Ofwat, on 28 May addressed to all water and sewerage company CEOs. The letter highlighted in general terms much of what we are saying in this response and with little deviation from the key concerns HBF has frequently articulated in its discussions with Ofwat over the last ten months. In particular, the issues surrounding each Company's Charging Arrangements and the so called 'balance'.

> "The general direction of travel with the proposed changes to the Charging Rules seems to be let the Water & Sewerage Company's come up with their own methods for calculating their charges, which will just lead to further inconsistency. This increases the risk of assumptions that we make at land purchase stage being very different to what we are actually charged at the delivery stage". (Developer C)

In our opinion, consistent with the responses received from many home builders, introducing the concept of 'netting off' income offsets/asset payments from the infrastructure charge appears somewhat premature. Until we have clarity and evidence-based transparency of cost reflective charges and in practical terms, what this balance actually means, it seems futile to go any further with what will be a substantial change in 'charging' on new developments. From HBF member's perspective many crucial questions remain unanswered.

One aspect of the consultation which is a cause of confusion for many home builders is the further explanation of the balance of charges on page 12. This seems to imply that in the ten areas in Annex A,

'like for like' charges/revenues recovered from developers will be broadly unchanged. We would like to meet with Ofwat to obtain a greater understanding of this from a practical perspective. Moreover, following a meeting with Defra on 24 May we have been made aware that the Department are intending to issue further guidance and explanation on this important issue in the near future. This only reinforces that part of our response relating to the prematurity of the changes planned for April 2020.

Several HBF members have raised questions about the definition of 'cost reflective charges'. It is an aspect of the consultation that is not defined and it would be useful if Ofwat could clearly state what does 'cost reflective' actually mean for Water and Sewerage Companies? From the information and data we have provided in appendices A & B it is clear that there is confusion about what can or cannot be attributed to a cost reflective charge. By extension, this has serious commercial consequences in the 'netting off' of income offsets/asset payments from the infrastructure charge. Similarly, what companies see as 'non-contestable charges' for SLP's when determining/ calculating income offsets. If 'netting off' is to be approached on a fair and equitable basis, both companies and home builders must be able to understand exactly what constitutes reflective charges, and for such charges to be underpinned by robust evidence. A failure here carries the risk of still having market dynamics that fall a long way short of operating on a level playing field.

We remain firmly of the opinion that 'netting off' of income offset/asset payments from infrastructure charges will not result in lower prices, as the consultation implies. In simple terms, the proposals will have a significant and adverse impact on developer cash flow, especially the primary business performance measure(s) of ROCE (Return on Capital Employed) and IRR (Internal Rate of Return) and ROA (Return on Assets). These are crucial commercial measures/benchmarks that provide investors, corporate lending institutions and analysts with key business performance ratios that influence investment decisions and ultimately, a company's share price.

Ofwat's proposals for 2020 may distort the financial balance to the extent that that they will favour the commercial interests of water and sewerage companies whilst putting effective sector competition at risk. Likewise, the expedited and increased delivery of much needed new homes.

In addition, given that over 50% of new housing is provided on land that has had a former use, no WaSC and/or WoC has demonstrated how infrastructure credits have been factored into infrastructure charges.

For reasons previously cited, we firmly believe the concept of 'netting off' income offsets/asset payments from the infrastructure charge is an approach that does not meet the Government's overarching principles of equitable balance, transparency, customer focused charging and fairness. We have set out below the rationale as to why we believe this to be the case:

1. Dwelling typologies and housing layouts vary considerably, influenced by site topography, ground conditions, development density and highway layout and these factors influence the extent and specification of the on-site water mains required. Therefore, averaging out charges is neither practical nor fair for all stakeholders.

> "…. Actual costs for each development should be sought and applied to ensure fair charges…. How are the averages calculated, demonstrated and presented in the PR19 submissions, are these checked and audited by an independent third party with no ties to the sector?" (Developer D)

One likely unintended consequence of averaging charges is that home builders on one site could be subsidising a peer company site elsewhere and potentially to a significant extent. This would constitute payment for works that are not project specific and therefore not a direct consequence. This would seemingly breach one of Ofwat's primary charging rules, as well as guidance handed down by Defra.

2. In the Gas, Electric and Telecommunication Sector, no Regulator has ever considered averaging out on-site infrastructure costs/charges. Home builder responses to this consultation gave a clear message that all costs within the curtilage of a development should always be attributed as actual costs, and should not apply any form of cross subsidy or averaging out. A development must be viable on its actual, site specific costs.

3. The relationship between the 'balance of charges and cost reflective charges' is far from clear. We would refer you to Appendices A & B which clearly identify significant inter-company variability.

4. The variability associated with many of the charges set by companies, in particular when assessed on a strict like for like basis, remains questionable. This begs the question as to whether they are indeed cost reflective. We again refer to the evidence disclosed in appendices A & B. The 'variability' issue has been recognised by Ofwat and whilst individual companies are being questioned by Ofwat on this issue, this is a matter in urgent need of resolution.

> "The cost differential between WaSC/WoC for the same work is too variable across the sector and must be explained with supporting examples to ensure that it is transparent, fair and equitable". (Developer E)

5. For the 'balance v cost reflective' charges to be fully explained by Ofwat and for house builders to have confidence in any charging regime, there is an underlying customer need for sufficient evidential granularity to be provided by all water and sewerage companies. This can only be achieved with the inclusion of worked examples in any consultation.

6. The way the consultation explains the balance of charges is far from clear and to quote a HBF member attending the HBF Water Matters Group meeting on 13th May:

> "The latest consultation is about as clear as mud". (Developer F)

Similar sentiments have been voiced by a number of Water and Sewerage companies, SLPs and NAVs.

7. To date, just a few companies have given a detailed methodology of how they have calculated their income offset. It has not gone unnoticed that these companies are the only ones that have applied the DADS calculation approach. The Ofwat Consultation is somewhat confusing in that on page 2 it says,

> "… the asset payment is required to be the equivalent to income offset if the incumbent had carried out the work".

Then on page 12 it states:

> "…. the only item that the rules do not require to be cost reflective is the income offset'.

It does not seem possible for it to be both. If you take what has been stated on page 2, if the incumbent undertakes the works then a totally different off-set calculation is undertaken and which varies from the income off-set and/or asset payment as presently defined. We would request far greater clarification be provided on this point.

8. In Appendix A, the section on income offset identifies considerable variability in a range of charges per plot – it also identifies varying contributing percentages when compared to construction cost. There is no explanation as to how each company has arrived at these numbers, even after drilling down into information contained on company websites.

9. In the consultation document, Ofwat states that it is the existing customer that provides the contribution to the income offset. This appears to be incorrect as it is income/allowances from the new homeowner that makes the contribution to the income offset. Until such time as a house builder completes a crystallised contract to purchase a site, there is little, if indeed any contribution from existing customers and/or water and sewerage companies. Moreover, the statutory obligations imposed upon all companies under the provision of the Water Industry Act 1991 (s37 and s94) cannot be ignored.

10. In assessing what an income offset should constitute as a contribution from the new homeowner/customer, we would draw attention to the fact that an established principle in the water and sewerage sector is that of developers gifting either a water or sewerage asset to a Company. These are income generating assets (in perpetuity) to which the sector contributes relatively little. This is a unique trading concept in any business relationship and it must be recognised across the charging regime to ensure fairness prevails.

11. In a report by Ofwat, relating to the monitoring of companies throughout 2018, in section 2.3.2 – 'Charges Engagement', Ofwat expressed their concern over the infrastructure charges, as imposed, as to whether they were fair and cost reflective. This chimes with the view of most home builders.

12. HBF totally agrees with the above point. Moreover, on-going assessments by HBF, relying on company specific evidence disclosed via Environmental Information Regulation (EIR) requests, are highlighting a number of issues surrounding the way Companies approach asset modelling to determine what offsite network reinforcement is required. The output from this modelling is clearly influencing the make-up of the water and sewerage infrastructure charge for many incumbent companies. Once completed later this year, HBF will publish its findings.

13. In evidential terms, it is quite clear that network capacity assessments specific to new development and which attempt to model the impact on existing water networks, are relying on input parameters that are not 'reflective' with considerable reliance being placed on theoretical modelling data. In addition to a number of identified inconsistencies, the output from theoretical asset capacity modelling is resulting in more water usage per property than is actually taking place. In addition, the statutory potable water use restrictions imposed by Part 'G' of the Building Regulations (125 litres/person/day) are being ignored by almost all water companies in favour of higher demand requirements - see Appendix E

"There is also a growing push to reduce this in many Councils to 110l/p/d in line with the optional requirements of the Building Regulations – how is this being considered?" (Developer G)

14. Appendix E also highlights the fact that some companies factor into their modelling, water lost through leakage when determining the demand for new developments. In addition, further allowances for fire-fighting purposes are also being included, despite the latter not falling within the scope of an s41-s44 requisition. Existing networks are also being modelled with high leakage allowances – leakage has been confirmed by Defra and others to be in the order of 23 – 25% of all potable water supplied. The corollary here is that the network reinforcement element of the infrastructure charge is likely to account for existing and in some cases, quite considerable asset leakage with the real prospect of home builders paying for consequential network reinforcement that is not in direct consequence.

15. With regard to the sewerage infrastructure charge HBF has produced at Appendix G evidence relating to the various site parameters being used by WaSCs. This first formed part of the work undertaken by the Defra Task and Finish Group in 2015/2016. HBF has continued to gather further evidence on this matter under the EIR legislation. This in turn has exposed a growing level of inconsistency – see Appendix F.

16. As can be seen from the data contained in appendix G, at the time (2016) there were already substantial inconsistencies in the parameters being used by WaSCs when modelling existing foul sewer network capacity. If the output from modelling is being relied upon to determine the network reinforcement element of the infrastructure charge over the ensuing five years, then not only could this charge be higher than necessary, it could also result in the home builder funding improvements/asset betterment works that are not in consequence.

17. Appendix G also shows that the greatest impact by far for many companies is from surface water misconnections into foul sewers both existing and those associated with new developments. In some instances, this can be in the region of 13 to 16 times the foul sewage discharge per property. We do not believe that this is right and our efforts to form a meaningful working group to effectively address this issue continue to be ignored. In many respects, misconnections are an illegal activity and outside the control of a home builder once a new home is handed over. Misconnections contravene existing legislation, yet developers are being required to fund it.

18. At Appendix F, and following further EIR requests, the WaSCs with the highest sewerage infrastructure charge apply these allowances for surface water misconnections when considering foul sewers on new developments. By comparison, the four WaSCs that don't approach matters in such a way and who fully accept their S94 obligations, have substantially lower sewerage infrastructure charges.

19. The issue is further complicated in that there is no data as to what, if any, surface water misconnections from new development actually discharge into foul sewer networks. Moreover, allowances for urban creep are overly conservative and no WaSC has conducted any investigative works at any location to ascertain on a more accurate basis what proportion of surface water run-off is being discharged into foul sewers. Within existing public foul sewer networks dealing with the consequences of misconnections and urban creep must fall to the incumbent WaSC,

otherwise developers are being penalised by having to fund network reinforcement that is not in consequence.

20. In relation to the infrastructure charge element of any Company's Charging Arrangements and given the information that HBF has provided, it seems somewhat futile to be looking beyond where we are today. Clarity, consistency and granularity must underpin any charging regime but at present this remains elusive. If the objective is to seek greater clarity and granularity from water and sewerage companies then this consultation falls short on both counts.

21. The above is further complicated by the fact that pre and post 1 April 2018 infrastructure charges do not fall under the same regulated criteria to be considered in the balance of charges. No scrutiny by Ofwat exists of the pre 1st April infrastructure charges to effectively include them in the balance post 1st April 2018. It is difficult to understand how reductions in infrastructure charges will be managed under rule 32 of the Charging Scheme Rules. The same applies to relevant multiplier reductions to infrastructure charges on bulk supplies to say flats, as well as commercial properties. The consultation is silent in these important areas and where companies continue to benefit from new build. This is unfair to developers/home builders and clearly distorts the 'balance'.

22. To expand on the above point, if Ofwat have concerns over what Companies are charging in their post 1st April infrastructure charges how can it be considered to be included in the balance of charges when there is no understanding or scrutiny of what the infrastructure charge funded pre 1st April 2018? It does imply that the existing customer base may well have obtained a major benefit as a result of revenue paid by developers through infrastructure charges, especially where network reinforcement did not take place and if it did, was it really needed? Therefore, should Ofwat be addressing this through taking infrastructure charges out of this balance of charges concept and focus on companies looking to provide cost reflective charges to address the many variances in charges identified in Appendix A & B?

23. Reference to the Southern Water website advises that infrastructure charges are payable for the following category of premises:

- Private dwelling houses
- Flats & maisonettes
- Sheltered Housing units
- Hotels & guest houses
- Retirement homes and nursing homes
- Hostels & student halls of residence
- Caravans, mobile homes and moored house boats
- Communal laundry, shower and toilet blocks
- Shops, commercial or industrial units, petrel filling stations or other buildings with domestic water fittings, e.g. WCs, washbasins

- Substantial extensions to the above

This is an extensive range of premises but no WaSC or WoC has provided any evidence as to what numbers of connections and/or revenue streams are attributable to each category. In the absence of any breakdown, it may well be that home builder IC payments are subsidising development that is not housing related and/or in direct consequence. Similarly, how the redevelopment of these sites has been reflected in the capital investment costs for new housing infrastructure as part of the IC income and expenditure process. Having to wait five years for any sort of income versus expenditure reconciliation is not appropriate in the circumstances. If sectoral trust and confidence is to prevail, this is vital information that must be provided. There are no indications that the current consultation will seek to address this evidential vacuum.

> "I cannot accept that the infrastructure charge can be the same for a development with both foul and surface water as it is for a development with only foul sewers". (Developer H)

The latter comment identifies yet a further anomaly associated with infrastructure charges in general and which is not addressed by this consultation.

24. With the income offset being equivalent to the asset payment HBF is aware, through Fair Water Connections, that there is an imbalance and a considerable range of non-contestable and administration charges levied on SLP's. This results in what may look as a commercially viable gross asset payment ending up being reduced to one where developers must make substantial contributions – evidence has already been disclosed to this effect. In some instances, the outcome is SLPs not being able to compete on a level playing field with the incumbent water company.

25. There are serious concerns that the consultation states that when the changes are introduced in April 2020, the developer will no longer benefit from the relevant deficit or commuted sum adjustment. Companies will quote on the same gross cost basis as the SLP - HBF see this as being unfair to developers in addition to distorting the balance.

26. The above criteria have been introduced for s98 requisitioned sewers. It is considered unfair and again must be seen as distorting the balance of charges for pre and post charges effective 1st April 2018.

> "The potential cost of requisitions, which could have a significant impact on our larger sites, as well as the impact on cash flow and viability …. We need to have greater cost certainty at the point of making land purchase decisions. I don't believe that the proposed changes to the Charging Rules will improve this situation". (Developer J)

27. Ofwat has stated in the consultation document these changes are necessary to prompt competition for NAVs. Over the last year HBF has been talking to NAVs who in turn do not seem to be of the same opinion as Ofwat on this issue. The barriers to entry to this market are a combination of a number of factors, for example, the time it takes for Ofwat to process a NAV application, DWI testing requirements on catchments, the lack of granularity NAV's are receiving from water and sewerage companies on Bulk Supply and Bulk Discharge Agreements respectively and the commercial margins at the site boundary.

> "Ofwat themselves appear to be the biggest barrier to competition in the water market. I have attached a copy of the NAV application which was first made on 30th May 2017 …. The site is nearly fully occupied … We are having to tanker sewerage away at considerable cost (circa £2000/week. If I had known my company would be put in this position …. I would have never recommended that my company went down the NAV route as the delays in appointment have resulted in a significant additional cost…. Why has it taken so long for Ofwat to grant the NAV on this site and provide a date when the NAV will be granted?" (Developer K)

This issue has already been relayed to Ofwat by an individual developer and clearly, delays of two years in the appointment of a NAV is unacceptable. What this case study identifies is just how important it is for a NAV licence to be granted at the important land acquisition stage and as part of the process for making key commercial decisions.

> "The NAV appointment process simply does not fit into the development programme without delaying housing delivery, so the process needs to be much more streamlined". (Developer L)

> "A reduction in timescales for the NAV to be able to obtain the appropriate licence must be reduced …" (Developer M)

28. In the consultation the issue is raised about a NAV not having the benefit of the income offset. It would seem that this would have more to do with commercial margins at the boundary of the site and how the new purchaser's bill is apportioned between the incumbent Water Company and the NAV?

29. One positive to emerge, as advised by NAVs and arising from Ofwat's Charging Rules is the removal of network reinforcement charges from requisitions. Home builders see this as one of the more positive outcomes from the introduction of the Charging Arrangements.

30. Lastly and probably the most important issue HBF wishes to raise is the way Ofwat see the application of the netting off of the income offset and the infrastructure charge. Appendix C is an Ofwat document about PR19 which states that there will be no credit, or payment from the Company, to the developer, if the income offset is greater than the infrastructure charge. Appendix D shows a schedule of known income offsets per plot/dwelling together with infrastructure charges for 2018-2019. Out of the seven companies in the schedule two will result in a credit or payment from the incumbent Water Company to the Developer - [redacted] identify a credit of £332 per plot, yet the Industry Regulator Ofwat have decided this will not take place. This seriously distorts the balance and can be viewed as possible market manipulation that has the propensity to work against developers and ultimately result in a level of financial viability that could undermine the delivery of new homes.

Summary

In the consultation Ofwat have simply asked just two questions. Regrettably, we do not believe these questions even begin to tackle the issues identified in both this and our response to July 2017 consultation. Moreover, in our opinion, for Ofwat to implement these new Charging Rules would contravene the 'charging rule principles' first crystallised by Defra in their guidance to Ofwat. Therefore,

we do not believe that a specific response to a very limited range of questions would make a meaningful contribution, hence the way we have responded and the supporting evidence we have provided.

The key to building trust and confidence lies in the disclosure of robust evidence underpinning any charging regime. We still do not have this basic requirement in place and the lack of direction and/or prescription in this regard by Ofwat remains a concern. This consultation provided a further opportunity for charging rule and charging arrangement clarity, consistency and granularity. It has neither secured nor contributed to the achievement of these key objectives.

Rather naively, it has been suggested in the consultation document that issues of costs can be an irrelevant consideration if known early enough, as they can be deducted from the land value when making an offer. Unfortunately, with other significant costs having to be factored into any land purchase appraisal, this approach carries a number of risks. For example, compromised viability, landowners unwilling to accept the land offer made and ultimately, an adverse impact on housing delivery or an inability to provide affordable housing. Home builders are not against paying for the infrastructure they need but wish to do so on a fair, equitable and proportionate basis. We don't not believe that this consultation addresses these basic customer requirements.

Finally, the more serious and concerning matter is the position Ofwat are taking as articulated in PR19 (see paragraph 33 of this response) and as documented/identified in Appendix C. This appears to have already been set in stone for six Companies who would have provided a credit to developers. Clearly, the balance continues to be distorted to the extent that it is becoming a means for the water and sewerage to capitalise on the construction and delivery of new homes.

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Home Builders Federation
HBF House, 27 Broadwall, London SE1 9PL
Tel: 0207 960 1600
Email: info@hbf.co.uk Website: www.hbf.co.uk
Twitter: @HomeBuildersFed