6. Emma Kelso's letter of 29 April 2019 requested that you urgently review your new connection charges to ensure that they are cost reflective, transparent and do not prevent, restrict or distort competition.

(a) Please provide details of what work you have carried out in response to this letter. If a review was carried out, please send us the conclusions of the review and explain how this has been communicated internally.

Each year the Company undertakes a rigorous tariff setting process when determining all of its charges. This process was refined, for the 2015/16 Charging Year, following the introduction of wholesale and retail charges.

The process for determining connection charges is part of the tariff setting process above, and includes stakeholder engagement and feedback, independent third party assurance on compliance and Board ownership and sign off. Given the size of our team both the Finance and Regulation Director and the Regulation Manager are closely involved in this process.

In recent years we have been active members of the WaterUK Infrastructure Policy Group (IPG) and understand clearly the changes in methodology that have been required to calculate Developer Charges. We have also worked with Frontier Economics to ensure the framework and methodology we apply is compliant with Competition Act and regulations.

Thus we believe our 2019/20 Developer Charges have both been subject to a rigorous process and complied with Ofwat regulatory guidance and principles together with the requirements of the Competition Act.

Emma Kelso's letter of 29 April 2019 highlighted four areas of concern. Management reviewed the letter immediately, reviewed our tariff methodology and approach and provided Executive Directors with feedback on each item.

Ofwat concern	Management Comment
Inconsistent application of methodology to calculating Asset Payment and Income Offset	Developer contributions and asset payments are applied consistently, whether the customer requisitions a main or opts to engage a SLP. For schemes totaling less than £100k in costs developer contribution of 30% is required for a mains requisition, and an asset payment of 70% is provided in the event of the developer opting for a SLP. This percentage allocation is based on analysis of historic run rates and is kept under annual review. For schemes over £100k we calculate contributions and asset payments based on the DAD calculation. This is explained clearly in our 2019/20

	Charging Arrangements.
Lack of clarity around charges and when they apply	Our 2019/20 Charging Arrangements provide a simple tick list showing which services are / and are not contestable.
Lack of cost reflectivity for design fees	Costs for design fees are a fixed rate, based on the time of our direct resource. Design costs are applied consistently to all developers and SLPs. This approach also applies to site inspections.
Absence of sufficient margin	We have no evidence, from Self Lay Providers, that the price we charge is not enabling them to operate on a level playing field in our region. Indeed we have seen a significant increase in Self Lay Activity over the last 18 months. We do understand the issue being raised by Ofwat and would welcome further guidance on how best to assess this issue.

The Management Review concluded that our charges were cost reflective and transparent, although the Executive Directors requested that it should be reviewed again when setting the 2020/21 Charges.

(b) What changes have you made to your charging arrangements since the letter?

In light of the review undertaken by Management and discussed with the Executive Team, the Company did not make any changes to its charging arrangements for 2019/20.

(c) What changes are you planning to make, and what are the timings for the implementation of change?

We are reviewing the impact of the new charging rules and have engaged Frontier Economics to support our work in this area.

We have already had informal discussions with developers and SLPs regarding our 2020/21 Charging Arrangements.

We shall be formally consulting with our developer customers in mid-November on our 2020/21 Charging Arrangements, and will be holding a Developer Forum, for developers SLP and NAVs in early December to obtain feedback.

Board Approval, following the process described above in response to 6 (a), will be given to these charges in January 2020, to meet a publication date of 31 January 2020.

7. Please explain how your charges reflect costs:

(a) How did you calculate the charges? What were your data inputs?

All charges associated with service connections and mains requisitions have been built up using an activity based costing approach. Charges are calculated from labour and materials costs associated with the undertaking of each activity including reasonable activity specific overheads.

The Company employ a Term Service Contractor (TSC). This contract was established under competitive tender in 2015. We received rates from 5 providers; we reviewed all of the tenders using a Cost Assessment Model, which analysed a number of scenarios – and established the best value service provider for all of the services to be provided.

We include the following cost categories in setting our charges.

Labour costs	Established from our TSC schedule of rates **or** based on the hourly rate of direct labour and the average length of time taken to complete the activity. Average time per activity is based upon detailed analysis of activity extracted from our ERP system. Own labour costs include NIC and pension contribution.
Material Costs	Materials costs are applied to each charge for the materials associated with that activity. The materials costs are taken from our latest purchase price for each part at the point in time that our charges are published. They are fixed at this point. Materials costs have an overhead of 16% applied to cover overheads associated with the management and handling of our internal Stores & Purchasing Department. This is based on a detailed activity base cost calculation using historic costs of the Stores and Procurement Department.
Management Overheads	Management overheads are applied at a rate of 10% on all rates for service connection and laying charges and 18% for mains connection and laying charges. This is based on a detailed activity base cost calculation using historic costs of the Developer Services Department in particular. (The supervision and management of mains connection and laying rates are higher than new services as the work involved with these installations requires more supervisory involvement).

(b) For requisition charges and infrastructure charges (and other charges if applicable), explain what you consider to be relevant drivers of costs and how these have been used to determine relevant charges.

For requisition charges, market labour rates and materials costs are the primary drivers. Labour rates were based on either our TSC schedule of rates or as described above for direct labour.

Given our TSC rates are fixed for 5 years (with an annual inflationary uplift) and contracts with material suppliers typically ranging between 3-5 years, short term stability is achieved with our costs (and therefore prices to developers). Therefore we do not anticipate any significant annual fluctuation in our mains requisition charges.

The infrastructure charge is based on the expected costs of providing network reinforcement works on a 5 year rolling basis, driven by new development.

Each year we review the expenditure underpinning this charge and the income we have received in the year and the charge is adjusted accordingly.

This process ensures that (over a five-year period) the charge accurately reflects our expected spend on reinforcing the network required to meet the requirements driven by new development. As a small company reinforcement work can be “lumpy” and, as such, this approach prevents significant price fluctuations.

Further we consider at a higher level how (in total) our charges for developers compare with our general charges to ensure we meet the principle that the balance of charges between customers and developers is broadly maintained. We have used assumptions from PR14 to ensure that, ex ante, our expected income from developers and other customers

Finally we charge diversionary work on a case by case basis, recovering reasonable expenses incurred based on time of relevant staff. Both network reinforcement costs and large diversionary work contracts are generally procured by a competitive tender process, to ensure we obtain the most competitive market price.

(c) Do cost drivers vary across your region? If so, how are, or will, these differences be reflected in charges?

Due the relatively small region we cover, cost drivers are stable and do not vary across our region.

8. Where you rely on contractor rates to determine cost, please provide more information about those rates:

(a) How are costs structured or formulated (e.g. are they based on a schedule of rates)?

Our contractor costs are structured by an activity schedule. So for example the service connection schedules is split into:-

- Excavation in 9 different surface categories
- Laying, jointing and installation on ancillary equipment
- Other services including proving supply, undertaking leakage checks and surveys.
- Reinstatement

For new mains requisitions a similar structure applies with the contractors rates broken down into the key components that form each part of the works.

Thus we have an agreed rate for each activity, not a cost reimbursable approach, to ensure the contractor has sufficient incentive to improve productivity and allow us to ensure prices to developers are constant.

(b) What services do contractor rates apply to?

Rates from our TSC are used to calculate all of our charges associated with mains requisitions and service connections; they do not apply to administration, traffic management or ancillary charges.

(c) What assurance can you provide that these rates are cost reflective? Please provide supporting documentation.

We undertook the market testing exercise in 2015 which confirmed that overall the rates from our chosen TSC were best value across all of the services provided.

In October 2019 we renewed this contract, but prior to doing so we employed a specialist procurement consultant who utilised [redacted] to review our contractor rates and base line costs. The Board of Portsmouth Water reviewed this exercise and were satisfied that, on balance, the rates of the incumbent TSC remained competitive in the market.

Further the contract provides for an uplift mechanism to be applied to the rates on an annual basis. There are two indices, the Civil Engineering Formula 1990 and the Building Formula Series 3, which are used as the basis of the annual adjustment. The Company are comfortable that by using this adjustment mechanism, future rates from our TSC will be adjusted to reflect any changes in market circumstances and hence our price to developers will be also reflect market conditions.