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Consultation on new connections charging rules for Welsh companies

We welcome the opportunity to provide Ofwat with our considered views on this important topic and we appreciated Ofwat's presentation regarding this consultation at our recently held virtual Developer Customer Forum.

We recognise the opportunities that are created by a new framework for the way developer services charges are regulated and the flexibility that this permits compared to the current arrangements being set out in primary legislation. However, we have several concerns related to the timing and timescales of the proposed changes.

Our response to the earlier consultation undertaken by Ofwat in December 2018 outlines a number of points that are still relevant to this consultation, particularly around customer engagement, implementation timescales and Welsh specific legal and policy differences including the changes that would occur as a result of the Wales Act 2017 being enacted. We expand upon these below.

Wales Act 2017

We understand from Defra that the Wales Act 2017 is now expected to come into force in 2024/25. It is important to consider its interaction with the timing of the proposed charges to new connection charging arrangements. Customers operating across the political border could face three different sets of charging arrangements in quick succession. We do not consider this to be in the interest of our customers.

Customer engagement

We understand from Ofwat that engagement with developer customers regarding proposed changes to charging arrangements for water companies wholly or mainly in Wales has been difficult and only a very small number of responses have been received. This is a concern, and we are very keen to support Ofwat to ensure any new charging arrangements meet developer customers' expectations.

We still believe that more in-depth and meaningful engagement with all developer customer types is necessary before any new charging approach is selected. This engagement activity in our experience

would, (given the range of developer customer types), usually take between four to six months to ensure customers have a sufficient understanding to make informed choices.

Review of charging arrangements for companies wholly or mainly in England

Over the last few years, we have observed the changes to developer services charging arrangements for companies wholly or mainly in England. The new charging arrangements have evolved each year, and this has led to a lack of clarity and increased customer dissatisfaction with the charges for development related activities. We understand further work is underway, by both Ofwat and WaterUK, to review and improve aspects of the new developer charging arrangements with these activities expected to be completed later this year.

We are surprised given Ofwat's assertion that differences between charging regimes in England and Wales may be detrimental that Ofwat appear to be rushing through rules in Wales before the conclusion of the English review. We are very keen to learn from the experiences encountered in England and believe it would be beneficial to customers and companies to delay implementation of revised charging arrangements for Welsh companies until after the issues in England have been resolved.

Timescales to implement

Given the need for further Ofwat consultation, publication of final rules, formulation of charges by companies, Board assurance and the timely publication of the charges themselves for application from 1 April 2022, we are concerned that time for meaningful and effective consultation with customers would be significantly constrained. We believe that a 12-month period should be allowed between the new charging rules being published and the date on which they would come into effect. This would provide sufficient opportunity to engage meaningfully with all customer segments including self-lay providers, NAV, housing association and housebuilders and allow scope for refinement based on their views.

PR19 and PR24

We are concerned that there that there may be unintended implications for companies and customers of a change in the basis of developer charges during the AMP7 period due to the PR19 developer services revenue correction mechanism.

The PR19 methodology introduced a separate correction mechanism for developer services and the correction mechanism is changed from an annual true-up in PR14 to a period end true-up for PR19. These changes mean that any fundamental change to the way that the charges are set during AMP7 could have a significant impact on either customer charges or developer services income until 2025. The Developer Services income included in the current PR19 Final Determination was set on the basis of the current charging methodology and assumes that this persists for the duration of AMP7. This has also informed the calculation of the average revenue to be used for the correction mechanism.

We also note that Ofwat are starting to discuss plans for the position of Developer Services in PR24 and this also suggests that it would be wise to delay the publication of the rules to ensure they align with whatever methodology is chosen.

For the reasons set out above we believe that it would be in customers interest to delay the implementation of revised new connection charging arrangements to be effective from 1 April 2025. This would align with the timescales for the introduction of the Wales Act and changes to the approach to Developer Services for PR24. It would also allow for the conclusions of the review into the implementation of the charging rules in England to be completed, avoiding the risk of further changes once implemented.

Of the options presented in the consultation, we believe that option 3 is the best option. We disagree with your stakeholder impact assessment. Option 2, by definition, is more restrictive than option 3 and would result in fewer opportunities for innovation such as our surface water removal incentive scheme. We hope any new charging framework would continue to provide the flexibility to deploy other innovative approaches that provide appropriate economic price signals.

A more permissive approach will mean that the range of potential benefits will be increased. Your analysis is flawed in being predicated on a belief that companies, under option 3, would set charges disregarding the views of customers or, at the very least "could lead to lower engagement without the right incentives or requirements." We believe that we are incentivised to engage with customers from the PR19 determinations, the D-MeX performance commitment and, more importantly, from commercial best practice, so that Ofwat's conclusion in the consultation is not sound.

In the same vain the assertion that differences between charging regimes in England and Wales may be detrimental is unfounded. The English regime is still being developed and so there is no reason to suppose option 2 will bring consistency. We are pleased to note the inclusion of a need for the rules in Wales to ensure environmental sustainability, this is a difference to the English Rules without being detrimental.

Responses to the specific questions raise in the consultation are set out in the annex. We look forward to engaging further with you on this matter.

Yours faithfully,

Eleri Rees

Strategy and Regulation Director

Annex - Dŵr Cymru responses to consultation questions

Q1 - Do you agree with our proposal to redefine what costs are recovered by infrastructure and requisition charges?

We agree that the proposed changes will simplify the process for recovery of the costs of network reinforcement works. The downside of this approach is that it could result in developer customers engaging with us at a later stage, which could increase the frequency of development and infrastructure programmes not aligning.

Q2 - Do you agree with our proposal that infrastructure charges should be calculated to recover costs incurred over a rolling period of years?

If there is to be a change in how the infrastructure charges are calculated, we support the intention to recover costs over a rolling period of years. This reduces the impact of the requirements of specific developments on the wider developer customer base. As developments will not necessarily incur the cost impact of their own network reinforcement (if the connections are in the same year as the works are undertaken), it makes sense to spread the cost across a range of years. It would also reduce the likelihood of significant short-term volatility in the level of the infrastructure charge following years where there has been an exceptional high (or low) network reinforcement expenditure.

Q3 - Do you prefer option 2 or option 3 (or another approach) as the basis for setting the relevant time period over which costs are calculated for the purpose of setting infrastructure charges?

If the relevant time period is to be aligned for water and wastewater, we suggest that 5-years is appropriate. However, that there is a difference between the both the level of costs and the expenditure profile of network reinforcement works for water and wastewater. In our experience, significant network reinforcement is much rarer on water schemes. In contrast, there is a greater level of volatility when network reinforcement is required for sewerage schemes, and the cost of these schemes is typically significantly higher. As there is a greater degree of variance in the expenditure between years it would be logical to opt for a longer period to assess the costs of wastewater network reinforcement. This would help reduce the impact of any exceptional schemes on the infrastructure charges by considering them across a longer time frame. As an alternate to options laid out in the consultation, we therefore suggest that a 5-year relevant time period could be applied for water, with a 10-year relevant time period for wastewater.

Q4 - Do you agree with our proposal to simplify the calculation of income offset and apply it to the infrastructure charge, instead of the requisition charge (thereby removing the need for asset payments)?

We agree with the proposal to simplify the approach to income offset and asset payments as set out in box 5.1. In particular, the proposal that "companies have flexibility in how they calculate income offset, subject to the requirement that the balance of charges that currently exists is broadly maintained" (p17).

We note that the definition of Income Offset in the draft rules for new connection services (Rule 5 (l)) is "Income Offset has the meaning given in the Charges Scheme Rules" but there is no such meaning given in the proposed charges scheme rules on pages 50-57 of the consultation. The current Charges Scheme rules "Charges-Scheme-Rules-1.pdf" has the definition in the box below which is not the same as the intention proposed in this consultation. The definition arising from the consultation is "**Income Offset** means a sum of money offset against Infrastructure Charges to broadly maintain the balance of charges between developers and existing customers as at 2021/22" and we propose that it is this meaning that is included in the Charges Rules. It is also the meaning encapsulated in Rule 19 of the draft new connections rules.

> "**Income Offset**" means a sum of money offset against Infrastructure Charges in recognition of revenue likely to be received by the relevant undertaker in future years for the provision of:
> i. supplies of water to the premises connected to the new Water Main; or
> ii. sewerage services to the premises connected to the new Sewer,
> and "**Income Offsetting**" shall be construed accordingly;

Q5 - Do you think option 2 or option 3 is the better approach to setting upfront charges for site-specific developer services? Or would you prefer another approach?

We consider option 3 to be the best of the options presented.

Option 3 would allow for a fixed up-front charge akin to option 2 should this be the preference once customers have been adequately consulted. Option 3 would allow alternative charging structures should they better reflect the feedback received from developer customers as part of the consultation process.

Q6 - Do you think option 2 or option 3 is the better approach to setting charges for requisitions and new connections? Or would you prefer another approach?

Option 2 is more prescriptive than option 3 and would therefore minimise the scope for us to align with customers' expectations. Option 3 would also allow us to innovate charging approaches more flexibly to incentivise good outcomes for customers, communities, and the environment.

Q7 - Are there any charging rules that have been included under options 2 or 3 that are not required due to the general requirements of the charging principles?

We are concerned that Rule 29 in its's current form may act as a disincentive for undertakers to upsize assets to consider future developments during the design of a scheme. The proposed rules advocate a proportional capacity split between the requirements of the initial development and future phases. This approach would always result in the costs associated with the scheme never being fully recovered from the developers of the site (in fact the recovery of costs could be minimal given nominal pipe sizes etc) and would presumably result in the deficit being borne by the wider developer customer base through either the infrastructure charge or other developer customer charges.

We request that Ofwat review sections 51A and 112 of the Water Industry Act 1991 to ensure the new charging rules provide a consistent approach.

The requirements proposed in the option 2 version of rule 43 state that the security should consider the "risk to be borne by the undertaker in carrying out the work in question." In the case of sewer adoptions and diversions the works are commonly carried out by a third party. This rule should be expanded to show that it

is also to address the inherent risk to the undertaker (and therefore the generality of customers) of those works being undertaken by a third party. This is of particular concern for us as we are subject to mandatory sewer adoption legislation (section 42 Flood & Water Management Act 2010) that does not apply to companies wholly or mainly in England. We require a surety (a bond or in cases where the surety is low in value a cash deposit) to be provided when entering into an adoption agreement. This is to:

a. Incentivise the developer to construct the new sewers etc to the required standard and where they fail to do this, we can call on the bond to fund remedial works to bring the system up to the agreed standard outlined in the agreement.
b. Protect those property purchasers who rely on the new sewerage system from the developer going into administration and failing to install the system or meet the standards required.
c. Protect us, and therefore the generality of customers, from incurring any costs resulting from the failure of the developer complying with the requirements of the agreement.

In any five-year period circa £250m of new sewers, lateral drains and pumping stations are constructed in our operational area and are incorporated into adoption agreements. If there was a reduction in our ability to hold sureties in line with the risk involved with adopting these assets, then it opens our wider customer base to the prospect of having to fund the rectification or replacement of substandard systems which we have an absolute obligation to adopt. Setting the right level of surety also incentives compliance with the Welsh Ministers Build Standards for Foul Sewers and sound workmanship from the start, and leads to earlier adoption by the undertaker, which is beneficial to the developer customer and those making use of the sewerage system. Prior to mandatory adoption being implemented for companies wholly or mainly in Wales, and the continuing voluntary arrangements for sewer adoption in England, the timescales for adopting assets could be prolonged indefinitely with many extending well beyond 20 years due to the lack of an incentive/obligation on the developer customer to conclude the process.

Q8 - Are there any additional charging rules that should be included under options 2 or 3?

We don't believe any additional rules, other than those outlined in other parts of this response, would need to be included in either option 2 or 3.

Q9 - What are your views on the three proposed options? Which of the options do you prefer? Would you prefer another approach?

We have already highlighted our view that any change to charging arrangements for developer customers must meet their expectations and this will require more extensive engagement given the very limited customer feedback received so far. The only option that provides sufficient flexibility to meet these expectations is option 3, however we believe more time is required to facilitate meaningful customer engagement and therefore suggest an implementation date of April 2022 is not in the interests of customers.

Q10 - Are there any other issues we should consider as part of our assessment of the impacts of introducing the proposed charging rules?

Please refer to the points raised in our covering letter