

TDS Response to the Ofwat Consultation on the Scope and Balance of Developer Charges and Incentives

Introduction

TDS is an Engineering Consultancy that operates throughout England and Wales. It is one of the leading Consultants in the procurement and project management of utilities for House Builders and Developers. We work in partnership with our Clients to provide various options in how utilities can serve a development in both a cost effective way as well as from a practical perspective on their development requirements.

We have an in-depth understanding of charges that our Clients pay to the Water and Sewerage Sector prior to and following the privatization of the Sector.

We have also been at the forefront of a number of important Ofwat Determinations against Companies which have been successful in securing substantial refunds to our Clients, notably the recent Final Determination for Linden Homes at the Novartis Development.

One of our main achievements was when we worked along side the QC's for Barratt Homes in the Supreme Court Case against Welsh Water in December 2009.

Q1 – Do have any comments on the key conclusions from the Frontier Economics Report?

Our first observation is that there has been a major opportunity missed with the lack of discussion/debate taking place between Frontier Economics with House Builders and Developers. Unfortunately, Frontier Economics have a limited practical understanding of the many issues that exists in relation to developer services, development and the Water and Sewerage Sectors. They openly admit that they have compiled this Report from the narrow perspective of economics.

We therefore have detailed below a number of importance aspects about this Report:-

1. One issue that neither Ofwat or Frontier Economics seem to be able to grasp is the fact that new on-site infrastructure is gifted to the Companies funded by the developer in full for sewers and SuDS and in part for water mains. To see these assets as a liability is a misplaced perception and fails to understand the increase in the customer base gifted to Companies so they can also obtain commercial benefits from the likes of advertising and selling of other products e.g. insurance for drains and water pipes.

The adoption of assets constitutes growth where a revenue is generated in perpetuity (Regulatory Capital Value). In the whole of the UK there is no arrangement that exists of this nature other than in the Water and Sewerage Sector where one commercial organisation (the House Builder or Developer) gifts, or part gifts, an asset to another commercial organisation (the Companies), which not only facilitates growth and additional revenue but

also adds value to a Company's Balance Sheet which in turn facilitates the Company's ability to borrow more capital.

Business utopia is growth, both House Builders, and Developers provide this to Companies as well as the opportunity to generate more profits. This is a major issue that this Report fails to recognise which is most disappointing.

The House Builder and Developer take all the risks in investment, and construction and the existing customer base and Companies receive a substantial benefit. It has long been our view that foul sewers adopted by Companies should have some substantial remuneration back to House Builders and Developers because they are expensive to construct and have a life span of many decades where little maintenance is required. This can clearly be seen by the Transfer of Private Sewers in October 2011 and Foul/Surface Water Sewer Pumping Stations five years later.

Therefore, House Builders and Developers should receive some element of remuneration. What Ofwat wish to call it, be it income offset, or any other name is irrelevant, the most important aspect of this is the business principle. As Ofwat are aware this is something which has been recognised in legislation for over 70 years, a point the Report has failed to understand.

2. The Report talks about the "user pays" principle and causation but fails to accept that all that House Builders and Developers provide is the funding for off-site reinforcement and the on-site infrastructure for both water mains and sewers. The "user" is the people who purchase the house or work in the offices or factories. There are a number of legal cases and QC's opinions on requisitioning that highlight this fact.
3. It is clear to see that Frontier Economics have no appreciation of the existing legislation requirements especially in relation to the changes they are proposing on strategic assets. It would be worthwhile if reference as well as an understanding of s37 and s94 of the Water Industry Act 1991 was to be considered in the Report. One issue the Report has failed to highlight is the proposal on strategic assets would need a change in legislation.
4. In the Report a number of quantitative assessments have been made which relate to the existing Charging Rules and Charging Arrangements, as we have explained later on in our response this cannot be relied on due to the turmoil and disarray that exists in the balance of charges and on-going discussions on cost reflectivity that have occurred for over three years since these Reforms were introduced.
5. As with other issues relating to charging, there is a lack of a Regulatory Impact Assessment (RIA) to support any of these proposals. This is a constant omission from every part of the Charging Rules by Ofwat since 2016 and if an RIA had taken place five years ago we would not be in the position we are in now as it would have been apparent that issues existed with the two principles of balance of charges and cost reflectivity. The need for a RIA was

a Government objective to Ofwat in their impact assessment to support the Water Act 2014, however this has never taken place.

6. From an economic perspective the Report fails to look in more detail about the unfairness in the way diversions are funded under S185 of the Water Industry Act 1991.

Why should House Builders and Developers have to pay in full for the replacement of aging assets which at one point in time will need to be replaced? From an economic perspective consideration should be given to a formula for deferment of renewal. In other words, the older the asset the greater the contribution back to the House Builder and Developer. The same principle should also apply to offsite reinforcement, again the Report misses this important economic concept.

7. The Report discusses the issue of newly constructed assets and maintenance costs. The problem here is that the whole debate is void of the granularity of costs attributed to the breakdown of customer bills.

New assets by the nature of them being constructed to the latest standards and thoroughly inspected by the incumbent Company (at the House Builders and Developers cost) will have lower maintenance costs against assets that are 50 years or 100 years old. There is no evidence in the Report to support the broad-brush statements that new assets also incur maintenance costs.

8. It is clear to see from a number of statements made in the Report that Frontier Economics have little to no understanding about development and house building costs. A house will only be sold for the market value regardless of the water and sewerage infrastructure required.

Another factor is that development can only take place where the Planning System and Planning Approval permits it to take place. It is a naive approach to think any differently.

The issue is, and has been since 1989, what is fair and reasonable for House Builders to pay for water and sewerage onsite and offsite infrastructure. It is an on-cost attributed to the development which is a factor in determining the viability to develop a site as well as the margin a House Builder and Developer wants to achieve. **The inconvenient truth is that over the last 30 years House Builders and Developers contributions have increased considerably and there is a total failure by Government and Ofwat to address this fact.**

9. The comparisons to the Electric and Gas Sector in the Report are really fascinating but are void of the facts and reality of how their charging mechanisms take place. These Sectors are now nearly fully competitive and are driven outside of the incumbents influence apart from the connection to their networks and reinforcement requirements. The incumbents rarely adopt

new assets however asset payments are received by House Builders and Developers by other independent asset owners.

It is also not possible to compare these utilities with the Water and Sewerage Sector because the legislation and principles have been accepted and in place for many decades.

Are the Charging Rules in Turmoil and Disarray?

The most fascinating and amazing admission in this Report is on Page 71 titled “**The definition of balance of charges**” to quote:-

“We understand that there is currently no agreed common definition of the balance of charges. Therefore, the concept of keeping the balance of charges broadly maintained is ambiguous, because it is not clear precisely what should be broadly maintained”.

So, it is not only House Builders and Developers that do not know what the balance of charges means, but also that the whole of the Water and Sewerage Sector are unaware of what the balance of charges represents.

If that is not bad enough the other founding principle is about cost reflectivity which also is under scrutiny over the last two years by Ofwat due to the vast variation in Companies Charges.

So how are Companies formulating their charges? The answer is probably by an element of guess work by what they think the balance of charges and cost reflectivity should mean, but more likely by mitigating their risk and loading costs onto House Builders and Developers.

Companies are by their nature risk adverse in their regulatory environment so they will therefore have no other option than to formulate their Charging Arrangements in way that defends their commercial monopoly advantage.

The only conclusion that can be draw from this is that as a regulator Ofwat has failed in their duty in the delivery of the Charging Rules. As three years on we are now having the debates on something that was highlighted to Ofwat over a number of years prior to the implementation of the Reforms and more importantly in factual and graphic terms in February 2018 before the changes in charging took place on 1st April 2018.

Q2 – We seek views on our reasoning and proposals with respect to charges for strategic assets, income offsets and the balance of charges rule?

It is difficult to see how any proposals can be given any serious consideration until the issues surrounding the balance of charges and cost reflectively are resolved. The landscape of what Companies charge House Builders and Developers need to be fully understood to enable any form of discussion, or debate to take place. It

is not possible to decide on issues for the future until the on-going disaster of Ofwat's Charging Rules has been satisfactorily resolved today.

Such proposals for the future must be totally transparent and supported by a regulatory impact assessment and in the short term this is not possible.

A number of issues raised in Q1 are pertinent to this question as well.

Q3 – What environmental incentives should water companies be offering developers and NAV? We are interested in examples of good practice. How can we do better?

As we have stated previously House Builders and Developers only facilitate the installation of the infrastructure as well as building the properties, offices and factories. The issue in House Building is how new customers can be influenced and more importantly their attitude to water usage. Also, as much as new developments can pave the way forward on this issue the larger challenge is with the existing housing stock which has substantially larger users of water and discharges of sewage.

In many ways the economic reality is that the Water Companies allowance will never cover the full cost of any environmental incentive there will always be a disproportionate cost having to be made by the House Builder and Developer.

Please see some ideas below in answer to question 3:-

1. There would be some major benefits for a drive to install smart meters in every new home, where customers can also see their water consumption. This has been a success in the Electric and Gas Sector.
2. Appliances being labelled on their water efficiency; this is more aligned to a Government issue than the Companies but the same concept for electricity has proven to be successful.
3. Infrastructure charge credits on redeveloped sites. Although this is a Charging Rule it seldom takes place and many Companies still do not give credits i.e. Affinity Water.
4. Ofwat refers to different types of water recycling which for managed properties like offices and factories is a viable proposition. However, on new housing developments it has proven to be difficult to achieve due to the continue maintenance requirements. Many House Builders have reported that many purchasers overtime have subsequently disconnected these systems when installed in a property. Also, in theory this can be seen as an acceptable way to save water but in practice these type of recycling systems are not so efficient with regard to the use of electric.
5. House Builders and Developers have for many years utilised SuDS on developments to control surface water discharges. A few years ago, one of our Directors was invited to Hampton Court Flower Show by Thames Water to

look at their garden. In this garden Thames Water had designed a planter/small attenuation system which was both functional and practical. It was like a water butt but with a planter. Ideas like this should be openly marketed to House Builders.

6. One issue which is of the utmost importance now is how the issue of nitrates are being dealt with by the Planning System. We are sure Ofwat are aware of the problem and here was a golden opportunity for the Sewerage Companies to stand up to the plate and say that it is their issue to resolve and is nothing to do with House Builders and Developers. (See s94 of the Water Industry Act 1991) However the Sewerage Companies are conspicuous by their absence.
7. One area which is in need of addressing is in relation to the modelling of foul sewers for offsite reinforcement, as well as the design parameters being used by Companies. The attached Paper set out the issues around both of these subjects.

Conclusion

We are sorry to say that this Report falls short on many accounts, and it would have been “richer” with the input from the Development Sector.

The inexcusable fact is that the existing Charging Rules and Companies Charging Arrangements need some major issues being addressed now:-

- a. Clarification on the meaning of “balance of charges”, with a definition that is understood by all?**
- b. What are cost reflective charges and the levelling out of Companies variations with regard to this matter.**

It is becoming clear to see that these two-founding principles of the Charging Rules are diametrically at odds with each other and are not achievable from a charging/costing perspective. It is therefore too premature to look to the future until the issues around charging are resolved today.