Our Ref: PK/LAT/Ofwat

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Dear Ofwat

Ref: Response to a consultation on updating Ofwat's charging rules

Please find attached SES Water's response to your consultation on updating charging rules.

If you have any further queries, please do not hesitate to contact us for further information or clarification.

Your faithfully

[redacted]

Paul Kerr
Group Chief Financial Officer

Q1: Do you agree with our proposed rule changes? Please offer alternatives if you think they would better achieve our intentions.

We agree and are supportive of the proposed rule changes.

Q2: Do you agree with our proposed changes in Appendices 1,2 and 3?

We agree and are supportive of the proposed changes in Appendix 1.

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Regarding Appendices 2 and 3, as a member of the industry working group, in relation to standardisation of terminology and worked examples. Our feedback has been gathered and consolidated into a sector response to this aspect of the consultation, which will be issued by Water UK.

Q3: We seek your views on our clarification of the five-year rule. In particular, we would like to know of any potential implications for charges and customers' bills from companies following our interpretation.

We welcome Ofwat's clarification on its interpretation of the methodology for setting the infrastructure charge. The Charges Scheme Rules (Rule 28) was not sufficiently clear to allow SESW to understand Ofwat's intended approach and as such was subject to some interpretation. For example, Rule 28 says:

> *"Infrastructure Charges must be determined in accordance with the principle that the amount of such charges will over each period of five consecutive Charging Years ending on 31 March 2023 and, thereafter, on 31 March in each subsequent year cover the costs of Network Reinforcement that the relevant undertaker* ***reasonably incurs*** (SESW own emphasis)*,* ***less any other amounts that the relevant undertaker receives for Network Reinforcement*** (SESW own emphasis)*, and before the application of any Income Offset."*

We interpreted the use of the terms "reasonably incurs" (as opposed to "reasonably forecasts") to accommodate reference to historic outturn expenditure as opposed to purely forecast expenditure. Furthermore, we interpreted the use of the terms "amounts that the relevant undertaker receives" to accommodate reference to outturn revenue collection instead of just expenditure.

The methodology used to calculate the infrastructure charge in our 2021-22 Developer Service Charging Arrangements therefore reflects outturn expenditure data and includes an adjustment for under/over recovery of revenues from the infrastructure charge in previous year(s). We believed reflecting outturn data was a sensible approach given network reinforcements will be partly anticipatory, partly reactive. The network reinforcements completed in t-2 will have been informed by the latest forecasts of the number of connections we expect to make in t.

That being said, we understand that, under Ofwat's clarified interpretation of Rules 28 of the Charges Scheme Rules, companies are expected to set their infrastructure charge:

- On a "wholly forward-looking" basis, reflecting the likely cost and likely number of connections over the following next five years, rather than considering a mix of actuals (ex post) and forecast data.
- Without "consideration of the variance between forecast and actual costs and revenues". Companies are not expected to adjust the infrastructure charge to allow for over- or under-recovery of developer services revenues, as these adjustments should be addressed

through PR19's Developer Service Revenues Adjustment Mechanism (DSRA) or the "normal in-period adjustment process for setting tariffs to match the annual revenue requirement".

Removing the retrospective adjustment for the variance between forecast and actual costs and revenues will have an impact on the infrastructure charge and hence on how much developer services customers will pay for a new connection. For example:

- Our estimate of the 2022-23 infrastructure charge (estimated as of today) would be £11/connection higher than under our existing approach to calculate the infrastructure charge. This is because reinforcement costs have been lower than revenues from the infrastructure charge in 2020-21.
- The infrastructure charge for 2021-22 would have been £97/connection lower (from £417/connection to £321/connection) than under our existing approach to calculate the infrastructure charge. This is because network reinforcement costs have exceeded infrastructure charge revenues in 2018-19 and 2019-20.

If this retrospective adjustment is removed to align with Ofwat's clarified interpretation, SES will need to ensure that the discrepancy between outturn network reinforcement costs and revenues from the infrastructure charge is accounted for elsewhere in such a way that SESW can recover its revenue cap. Ofwat has suggested to account for the variance between forecast and actual costs and revenues through PR19's regulatory tools such as DSRA and in-period adjustment.

The DSRA does not appear to be the appropriate tool for incorporating this adjustment. The DSRA mechanisms adjust DS revenue for the discrepancy between actuals and forecast number of new connections. It does not directly or fully reflect discrepancies between forecast and actual costs or between forecast and actual revenues. The DSRA keeps the unit rate (cost) as calculated ex-ante at PR19. As such no cost adjustments are made as part of this mechanism.

The other tool quoted by Ofwat is the normal in-period adjustment process for setting tariffs to match the annual revenue requirement. If Ofwat's intention is therefore for SESW to include any over- or under-recovery of developer services revenues (and the infrastructure charge more specifically) in the in-period adjustment process for setting water wholesale charges, the impact would be borne by SESW's wider existing customer base as opposed to SESW's DS customers. In the 2021-22 example above, the proposed approach would not have resulted in lower charges for all consumers but simply would have redistributed the burden of network reinforcement cost under-recovery away from developers and towards existing customers; this would unavoidably create implications for the balance of charges.

We confirm that for our 2022-23 Developer Services Charging Arrangements, we will set the infrastructure charge on a wholly five-year rolling period. As Developer Services are included within the single till revenue cap, any variations in the infrastructure charge ex-post will be captured as an adjustment to wholesale water charges to calibrate revenue recovery to ensure SESW remains within its revenue cap.