TDS Response to the Ofwat Consultation on Updating the Charging Rules – published 8th June 2021

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 Client's 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 Client's 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 Client's, notably the recent Final Determination for Linden Homes at the Novartis Development.

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

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

Our section-by-section response(s) relating to this question follows:

Section 3.2.1 – Charging Publication Dates

Agreed.

Section 3.2.2 – Publishing Statements of Significant Change

We consider these should be published on 1st February.

Section 3.2.3 – Cost Reflectivity – This constitutes the biggest issue in this Consultation.

Over the last four years issues surrounding cost reflectivity and the variation in charges for "like for like" issues between Companies have been highlighted to Ofwat. Last year Ofwat pledged to investigate this matter further and explain why these variations exists and we quote:-

"We consider that the differences in levels of charges are so marked that they are unlikely to be a function of cost alone. Such problems may undermine key principles of our rules, including that the charges are predictable, transparent and fair."

Other statements made by Ofwat emphasised the severity of this issue. From a House Builder and Developer perspective cost underpin viability and are also one of the most important aspects of the regulatory regime. Therefore, as this was an issue highlighted not only in the last four years but also in 2009 by the Gray Review we would have expected Ofwat to have undertaken a forensic analysis of what the problems are and how they will be resolved.

So, what do we get from Ofwat as a solution to this matter is a fourteen-word new rule which says nothing about why or what it means.

Furthermore, the external Consultants investigation into this issue has not been disclosed with this Consultation which is most concerning and begs the question why has Ofwat not published this Report?

These fourteen-words goes nowhere near addressing the issue of cost reflectivity. This whole situation is even more serious, as not only is there vast variation in charges but costs in relation to on-site water mains, sewer requisitions, admin charges and other costs have and are increasing substantial since 1st April 2018. If there is an issue with cost reflectivity it has a snowball effect on everything including income offsets.

From our Client's perspective Ofwat needs to explain what analysis of costs has taken place as well as how they have come to this new rules fourteen words and position. More importantly what actually does it mean? With the balance of charges being seen as unexplained and ambiguous and with this matter being far from transparent the only

conclusion that can be drawn is that the Charging Rules are in disarray and turmoil which constitutes one of the biggest regulatory failures that has ever taken place in this sector.

Section 3.2.4 – Consistent Terminology

We are aware that Company Consultations are taking place on this issue but to be frankly honest the whole aspect of consistent terminology does seem a bit of a smoke screen. What we are talking about here is not a complex area of construction requirements.

3.2.5 – Using Worked Examples

These are very useful, helpful, and informative and something that we have supported but here again we see the introduction of a new term, namely, "*parent main*".

It seems somewhat ridiculous that into the fourth year of the Charging Rules and Charging Arrangements both Ofwat and WaterUK are still trying to sort this matter out.

Is it not apparent to Ofwat yet that WaterUK are not the best organisation to address any issues relating to the Charging Rules because of their vested interest to the Water and Sewerage Companies as well as the Water only Companies? It was WaterUK that have been tasked with many aspects of sorting out the detail from the Charging Rules and here we are into the fourth year of this Regulatory Reform still no further on than were we where on 1st April 2018. In fact on many accounts House Builders and Developers are a great deal worse off financially.

Section 3.2.6 – Where to issue rules on infrastructure charges.

No issue here, but again why has it taken so long to appreciate that infrastructure charges need to be in the Charging Rules?

Section 3.2.7 – Income offset and connecting to existing mains.

The issue we have with this is yet again the whole definition and explanation as to what income offsets are meant to be is missing. Going back to 2018 it was stated that income offsets were asset payments.

What are they now in quantitative terms is far from clear and needs a further explanation from Ofwat? This is a major issue and is in urgent need of clarification.

Section 3.2.8 – Network reinforcement and NAVs

The way this section of the consultation is written it implies the developer will be paying additional network reinforcement changes, over and above the relevant infrastructure charge, in the event developers chose to opt for a NAV.

If this analysis is correct, it introduces a level of commercial risk that will work against the appointment of a NAV. As Ofwat know, crucial commercial decisions are crystallised by developers at the critical land acquisition stage – a point in the development process when a NAV is unlikely to have obtained the required licence/Ofwat approval. The potential risk to project viability would be such that a developer would likely run with an Incumbent's costs and charges given the certainty it would provide. Moreover, **NAVs have already confirmed that if additional network reinforcement costs are applied by water and sewerage companies, as proposed, it will be deemed a legitimate *"pass through cost"* to be paid by the developer. This is considered inequitable and creates further uncertainty that undermines competition from NAVs.**

Section 3.2.9 – Quotes spanning different charging years

The approach suggested in section 9 of Appendix 1 is acceptable, save for the caveat that once costs and charges are crystallised, they should endure for the lifetime of the site and/or phase under construction but limited to a long stop date of 2 years given the persisting low level of inflation and the 3+ years companies have had to interrogate and justify their costs and charges. Rules will need to be re-considered if this recommendation gains traction.

In addition, what if developers are willing to pay upfront in order to crystallise costs for the duration of the project/construction phase? This too should be recognised.

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

We would express a number of concerns.

The worked examples are far too generalised and need to include much more detail, i.e., inclusive of a complete range of cost elements, and how they have been determined.

More importantly, the provision of supporting examples should be mandatory rather than remain discretionary. Furthermore, by providing an increased level of detail, inclusive of more specific information relating to metering arrangements and costs, allows for a more expedient and timely dispute resolution process involving the Incumbent. Greater evidential transparency in cost structures and their component costs is essential and carries the potential to reduce reliance on the formal determination process for dispute resolution. By providing much improved cost granularity will also allow developer customers to better understand and compare what competing options may be more commercially attractive, in addition to providing evidence that is so crucial in determining value for money.

In considering the amended terms/definitions we would offer the following comments:

- **Administration fees and supervision/inspection fees** are entirely different – they require separate definition/explanation.

- **Section 37 and Section 94 statutory duties (WIA 1991)** need to be recognised and defined. Likewise, how these duties to provide and maintain adequate water and sewerage infrastructure are accounted for/discounted in arriving at network reinforcement costs and infrastructure charges that are wholly in consequence.

- **Barrier Pipe** needs to be defined, together with the circumstances and ground conditions which require it to be specified. This is an area where water companies not only apply impractical and subjective criteria, but it is also an area where the disparity in Company costs is staggering for a product that has a solus water Company defined specification with material cost being the only difference.

- **Bond or Surety** – should include a reference to established new home warranty providers such as NHBC, and who offer such a service.

- **Building Water** – needs to be defined and likely costs stated. How this is to be delivered also needs to be explained, i.e., separate metered connection or utilisation of a future new home metered connection or just a flat fee. If flat fees are to be applied the justification for such should be clearly presented. It should also reflect on the move to off-site production and the declining use of on-site water for construction purposes.

- **Communication Pipe/Service Connection/Supply Pipe**– we have long advocated the inclusion of a simple diagram that defines each component from a connection to the distribution main to the stop cock in each premise. This simple diagram can be adapted by each company to define what is required and relative to each aspect of the legislation. Likewise, what is/is not non-contestable, together with the required metering specification/arrangement and who is/can be responsible for providing each element of the work. Metering arrangements are a particular grey area, likewise the costs associated with such.

- **Design Fee** – how are we to know design fees are cost reflective? Are the various cost headings and actual related costs, including the make-up thereof, to be included? We see no reason why this should not be the case.

- **Developer Customer** - this needs wider definition as it can also include a JCT appointed contractor under a design and build contract.

- **Diversion** – needs to be defined but also recognition that; (a) some companies allow for a contribution to the cost of diversion based on the established principle of the developer providing asset betterment, (Bacon/Woodrow formula), or (b) the presence of lift and shift clauses in formal easements that require the water or sewerage company to bear the full diversion cost. As a sub-definition, lift and shift clauses need to be recognised and defined.

- **Fire Hydrants and water for fire-fighting purposes** – needs to be defined. This is important given the recently introduced mandatory Gateway 1 process requiring a fire risk assessment and mitigation report that will need to accompany several residential planning applications from hereon.

- **Footpaths** can also incorporate vehicle crossings and grass service verges – this needs to be recognised.

- **Infrastructure Credits** – this needs to be better defined to remove the arbitrary criteria that is applied by certain WaSCs/WoCs, typically, Yorkshire Water (and other Companies) who do not recognise IC credits on sites that have had a former use and connected to YWL water and sewerage assets. Even WaterUK has stated all redevelopment should have IC credits but many Companies do not recognise this.

  A major issue that Ofwat have failed to understand with this matter is the need to change Condition C from a Common Billing Agreement for all new properties to ones which are billable. If you have a block of flats with one mains supply over 32mm that are billed individually Companies will not apply IC credits due to the wording of Condition C. However, if you have a Common Billing Agreement you will get IC credits. Why is there any difference in the network reinforcement and infrastructure charge requirement due to the billing?

- **Road** – As a general term it has no legal definition. Conversely, certain road categories are defined by statute , i.e., Special Roads, Trunk Roads, Classified Roads, Principal Roads, County Roads and Main Roads, Metropolitan Roads and Greater London Authority, Strategic Roads in London, Roads used as public paths, byways open to all traffic and restricted byways - see Highways Act 1980.

  That said, the term 'Highway' has never been defined in explicit detail, but it is nonetheless defined by statute as – "*a Highway that is open for use by the public*", i.e., by pedestrians and vehicles respectively. It does not extend to include private roads, bridleways. In many respects, the best definition is that of 'carriageway' – see S329 of the Highways Act 1980 (interpretation):

  "…. carriageway means a way constituting or comprised in a highway, being a way (other than a cycle track) over which the public have a right of way for the passage of vehicles"

For simplicity and to avoid unnecessary semantics we would be inclined to suggest to Ofwat that it is perhaps more appropriate to state something along the lines of -

"Carriageway/Highway - see Section 329 Highways Act 1980".

Anything else takes you into the grey area that is complex Highway Law.

- **Point of Connection** – in the context of foul sewer connections this definition needs to be carefully considered to ensure it does not undermine established case law relating to the absolute right to connect to the public sewerage system, irrespective of the size of the receiving foul sewer.

- **Sustainable Drainage Incentive** – how is a cost reflective deduction determined? Moreover, these reductions should be mandatory not discretionary and secured by way of clearly defined, specific criteria. Some companies ask for verification of water use before offering a deduction – how is this to be managed? How will this deduction be treated alongside sewerage infrastructure charges, i.e., a 50% reduction in the sewerage IC if no surface water discharge to sewer? Greater clarity of definition and applicability is required.

- **Traffic Management Charges** – requires definition with the particular strand of legislation clearly identified.

- **Road Opening Notice** – needs to be acknowledged and defined

- **'Upsizing'** and what this constitutes and how it is to be funded requires definition.

- **Water Efficiency Incentive** – the current range of incentives is from £0 to a nominal amount and accompanied by a differing and somewhat subjective range of water use targets. Why not standardise this across all companies but more importantly, define how it is to be achieved, taking cognisance of the low water use requirement in defined water stress areas.

- **Small Company** – reference is made to such but how is it defined, i.e., turnover?

Q3 – We seek your views on 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.

How infrastructure charges (ICs) and in consequence infrastructure capex has been determined remains a matter of some concern for the Developer Community in general, especially that portion of ICs allocated to network reinforcement. Water and sewerage company expenditure on infrastructure is considerable **– what developers do not know is precisely what infrastructure, and the value thereof, is actually attributed to new residential development.**

For example, does developer services related infrastructure investment also include certain types of non-residential development that have high water use/drainage discharge – typically, hotels, halls of residence, nursing homes etc? Moreover, annual company accounts do not provide sufficient detail in this regard. Our view and that of our Client's is that the time has come for such crucially important information to be disclosed in full.

Furthermore, how water and sewerage company statutory duties under S37(1) and S94(2) of the Water Industry Act 1991 are taken in consideration when determining the quantitative aspects of ICs remains elusive.

This applies equally to both the physical extent of any works and the costs thereof. In many respects developers are confronted with non-existent quantitative and qualitative evidence, accompanied by an underlying reluctance on the part of water and sewerage companies to disclose information.

From 1989 to 2018 House Builders and Developers have had to accept the failure in the regulation of infrastructure charges by Ofwat where now the Regulator admits that double accounting more than likely took place. We can therefore only conclude more accountability is required.

There was a suggestion that an annual reconciliation of ICs and subsequent disclosure by each water and sewerage company would take place, but this has not happened. At present, there is little comfort for the Developer Community that the infrastructure payments made

since April 2018 have been invested in infrastructure projects that are exclusively related to new residential development. Asset betterment, using house builder paid Infrastructure charge revenues, and which favours existing customers, remains a very plausible eventuality given the evidence vacuum that persists.

Even a crude annual analysis would help dispel such concerns, but the fear is that 5 years is a long time for water and sewerage companies to readjust their position in the absence of any attempt by Ofwat to ensure a regular (annual) audit is undertaken.

In reality, developers have little faith in infrastructure charges being representative and it remains moot whether the proposals advocated in this latest consultation will yield the robust evidence and data to reset the benchmark from 2022/23, especially on a fair, proportionate and equitable basis.

The recent Novartis determination and which saw Southern Water having to return over £500k to a major House builder, provides unequivocal corroborative evidence .

In our view how asset capacity modelling is undertaken and how it is to be used to inform the extent and cost of network reinforcement on a legitimate and representative basis, should be the first step before embarking upon a revised process for infrastructure charge reconciliation. That said, any de minimis reporting requirement should ensure there is project specific disclosure, inclusive of costs, together with the number of related new connections that have supposedly been catered for. This constitutes a major flaw in Ofwat's rationale in this area.

A further anomaly will be the impact water and sustainable drainage efficiency offsets will have on both network capacity, (principally water infrastructure) and infrastructure charge revenues and related expenditure. This may be a difficult conundrum to reconcile but it is reasonable to assume, as with any business, all water and sewerage companies have the requisite evidence in place to allow them to make informed decisions.

We would some suggests below:-

- The availability of adequate water infrastructure is a material consideration for any Planning Authority's Local Plan and/or Core Strategy – a procedure that also defines where and when development is to take place. As such, it affords water and sewerage companies[3] sufficient forward visibility to assess network capacity and to make related infrastructure investment decisions, thereby ensuring the Government's objectives relating to new housing provision can be realised.

- The statutory duties imposed on all water and sewerage companies can be duly considered and reflected/discounted from the network reinforcement element of infrastructure charges to arrive at ICs that are wholly and clearly defined as being 'in consequence'. **(One of Defra's underlying principles).**

- Having identified, (a) the infrastructure needs on a project specific basis, offset by a company's underlying statutory duties, (b) the likely/budget cost thereof, and (c) the projected number of new home completions/connections means a far more accurate and representative assessment of water and sewerage infrastructure charges is possible, especially the network reinforcement element.

- **Thereafter, an annual audit/reconciliation, that also captures local authority housing completion numbers (a mandatory reporting requirement of Government) enables water and sewerage companies to undertake the following:**

    a. **A comparison of forecast against actual expenditure in relation to 'in consequence' infrastructure that should/has been provided'**

    b. **A reconciliation of actual versus forecast connections**

    c. **A recast of the likely infrastructure investment in the subsequent charging year and included as a crucial component of a company's annual charging arrangements**

    d. **A rebalance of water and sewerage infrastructure charges to minimise under or over recovery in the planned 5-year period**

In many respects what we are advocating is a process that follows basic business/corporate management that most UK businesses apply. It is also an essential requirement for any business when auditing annual company accounts.

6th July 2021