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Ofwat
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5th July 2021

By E-mail: charging@ofwat.gov.uk

Dear Sirs,

RE: **CONSULTATION ON UPDATING OFWAT'S CHARGING RULES – PUBLISHED 8TH JUNE '21**

W A Consultancy provides advice and guidance to a number of Developer Clients, in addition to established Engineering Consultants on all aspects of Water and Sewerage infrastructure provision. Our Consultancy also continues to be retained as an expert witness on planning, sewerage/drainage matters and key aspects of land acquisition due diligence. With over 50 years' experience in a crucial part of the Utility Sector, augmented with sector specific research and access to client disclosed evidence, W A Consultancy is well placed to provide a balanced and unbiased perspective of the efficacy and equitable fairness of the charging regime confronting the Developer Community. We therefore trust our response makes an effective contribution to the consultation process and that it will be afforded full weight and respect. Moreover, we are happy to confirm our willingness to participate in any follow up evidence-based discussions.

1. GENERAL COMMENTS

1.1 It is not clear in the consultation whether or not the proposed changes either require or already have Secretary of State approval – is this still a requirement?

1.2 **Expectations were high that this consultation would, out of necessity, be informed by a relevant report prepared by SIA-Partners – a commitment given by Ofwat but not delivered.** Having been commissioned by Ofwat, the final report (presented to Ofwat in April 2021) supposedly distilled the outcome of an analysis of company charging arrangements and related company information. However, we have been advised that the final version of the report was subsequently amended at Ofwat's request in early June. Given the relevance of this report and the fact that Ofwat confirmed it would be a material inclusion as part of this consultation, we remain unsure as the reasons for its' non-disclosure? In many respects, it is difficult to provide a meaningful response in the absence of such important, material information. We therefore wish to reserve our position to amend our response to this consultation following the eventual disclosure and our review of the SIA-Partners report.

1.3 Our clients' have commented on the timing of this latest consultation, i.e., being so soon after a related consultation closed on the 8th June 2021. Moreover, as highlighted in our response to the latter, **whist the balance of charges remains undefined or at best ambiguous, (as confirmed by Frontier Economics) likewise, what actually constitutes cost reflective charging, it is difficult to understand the rationale for the latest consultation whilst there are such critical evidential gaps**.

1.4 In addition to ourselves, clients continue to raise concerns about the concept of "*principle-based charging rules giving companies flexibility to innovate in how they calculate and present their charges*". Flexibility remains conspicuous by its absence but conversely, the disarray in company

charging arrangements is an issue of concern that has persisted for over 3 years. Our collective view is that a more prescriptive analysis and approach to company costs and charges is required.

1.5 In section 3.2.3 of the consultation a new term has been introduced, i.e., "*long run costs*" but with no accompanying definition and/or explanation. During the consultation period we approached Ofwat directly and requested clarity on what this term meant/referred to and how it would influence company charging arrangements, if at all. In subsequent e-mail correspondence, Ofwat confirmed the following:

> ***"Our charging rules give companies flexibility to choose how to set their charges, hence we do not currently define long run costs".***

A somewhat confusing and unhelpful response and one that could be construed to be more aligned to the concept of **allowing companies to freely apply whatever subjective criteria to costs and charges they consider appropriate given there is no effective evaluation or verification mechanism in place**. Moreover, having spoken with water and sewerage companies, they too have no idea what long run costs are meant to be, or for that matter how they are expected to inform their costs and charging arrangements. Clarity in this area is therefore essential to assist and inform all partner and stakeholder interests.

2. RESPONSES TO SPECIFIC QUESTIONS

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 - Proposed Changes

Section 3.1 Summary (Table 1)

See earlier comments regarding what constitutes "*long run costs*" and the definition/applicability thereof.

Section 3.2

We do not believe the proposed changes will reduce the potential for confusion. **Whilst the balance of charges continues to lack definition and remains ambiguous**, likewise **what constitutes cost reflective charging**, confusion and charging disarray will prevail. Our collective view is that Ofwat must be more prescriptive in its management and control of water and sewerage company costs and charges, especially if trust and confidence in the sector is to be realised. **(A key Defra principle).**

Section 3.2.1 – Charging Publication Dates

Agreed, but with two caveats, i.e., small companies should also publish on 1st February. Secondly, costs and charges must be supported by robust evidential data, i.e., how they have been apportioned/determined and the quantum associated with each component of cost. This provides the means to effectively consider and compare terms, conditions, and costs from competing infrastructure providers. **It also meets the Defra requirement for evidence-based transparent charging.**

Section 3.2.2 – Publishing Statements of Significant Change

We consider these too must be published on 1st February, inclusive of a detailed explanation as to what aspects of company costs and charges have undergone significant change and supported by the necessary financial evidence/reasoning.

Section 3.2.3 – Cost Reflectivity

See earlier comments relating to "*long run costs*" and what they are meant to be. Likewise, our comments relating cost reflectivity. As articulated in our response to the May 2021 consultation, until cost reflectivity is properly defined and understood by all, the raison d'etre for any consultation that continues to rely on such definition(s) is, to a degree, meaningless. Similarly, it only adds to the golden thread of complexity and confusion associated with the charging rules/company charging arrangements and which continues to persist. It is also wasteful of resources, including those of Ofwat.

Section 3.2.4 – Consistent Terminology

Only one company has taken the time to discuss terminology with us and at a very late stage in the consultation proceedings. Moreover, to expect partner and stakeholder interests to hold 17 such exchanges with each company, within a consultation timescale that is effectively just 20 working days, and to expect the outcome from these exchanges to inform any related response as part of the consultation process, is heroically aspirational. In many respects we have effectively given up trying to work collaboratively in such short timescales, especially when our experienced-based contributions and sensible recommendations are often turned aside.

3.2.5 – Using Worked Examples

These are always very useful, helpful, and informative but here again we see the introduction of a new term, namely, "*parent main*". More telling is the fact that examples 3 and 4 are effectively the same housing scenario – the only difference being which entity undertakes the excavation. The latter activity has no association with whatever a 'parent main' may be so why the introduction in example 4 and again in example 5? This is only adding to the confusion and having approached water companies for guidance/clarification they too can't understand or answer the question as to what this term is meant to embrace. **That said, what is more concerning is that of having formally asked Ofwat to provide some degree of clarity during the consultation period our request has been totally ignored.** This hardly creates a sense of trust and confidence.

Perhaps the acid question is one of having previously identified a disparity in costs that is so significant that they defy logic, what are Ofwat's intentions should the same disparity in costs manifest itself as a result of this particular consultation? Will there be targeted and/or corrective intervention? See also concluding comments regarding cost disparity, inclusive of supporting evidence.

In addition, the narrative accompanying the term parent main refers to "*serving 150 existing customers*". As "*customer*" is not included in the current schedule of terms and definitions does this relate to individual customers or individual dwellings? The difference in water demand between the two is considerable.

Section 3.2.6 – Where to issue rules on infrastructure charges

No major issues here.

Section 3.2.7 – Income offset and connecting to existing mains

The Ofwat consultation that closed on 8th June advocated the abolition of income offsets. Has the recommendation in this regard and made by Frontier Economics been rescinded? In our view, income offsets should continue and reflect a more equitable offset to house builders that accounts for the significant income stream water and sewerage companies gain from freely gifted income generating assets - conservatively estimated at around £500M over a 5-year AMP period. Ofwat has stated in its schedule of definitions that income offset - "*is recognition of revenue likely to be received by the Undertaker in future years*". **In reality, the average income offset across the sector hardly equates one year's domestic water and sewerage bill and remains discretionary.**

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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 implied, 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.

In addition, and perhaps more telling, is how would water and sewerage companies possibly know when a NAV is likely to be appointed in advance of a formal licence application? Likewise, to what extent would a water and sewerage company be able to gauge the impact on its network(s) arising from a future NAV appointment? This proposal needs far more rigorous consideration and explanation given the potential impact on developer/house builder decisions, especially when considering and comparing the commercial aspects of alternative means of infrastructure procurement.

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 and Ofwat has had to interrogate and justify costs and charges. Rules will need to be re-considered if this recommendation gains traction but as with most of our customer generated suggestions we suspect it will be given scant consideration.

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?

Not entirely – see earlier responses.

In addition, 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 calculated/determined and collated. 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 it allows developer customers to better understand and compare what competing options may be more commercially attractive, in addition to providing evidence that is so crucial to 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 clearly defined. Likewise, how these duties to invest, provide and maintain adequate water and sewerage infrastructure are accounted for and 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, (even on greenfield sites) 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 – see earlier evidential submissions made to Ofwat in 2018/19 but once again, largely ignored by Ofwat.

- 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 the move to off-site production and the declining use of on-site water for construction purposes, for example, off-site, pre-mixed cementitious products and materials.

- Communication Pipe/Service Connection/Supply Pipe– we have long advocated the inclusion of a simple diagram that defines each component (and its cost) 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 wide disparity in 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/disclosed? 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. It can also include housing associations and Registered Social Landlords (RSLs) – see also the required link with water asset adoption codes and the multiple signatories to self-lay agreements etc.

- 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, (application of the 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. Several companies are engaged in asset replacement programmes involving asbestos cement pipes/watermains given their questionable integrity and potential compromises to public health. Surely, in such circumstances, the developer contribution should be minimal?

- 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 1st August 2021. (Ref: MHCLG - Building Safety Bill/Legislation – Annex A).

- 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, who do not recognise IC credits on sites that have had a former use and connected to YWL water and sewerage assets.

  As an integral part of our response, we would ask that Ofwat give far greater consideration to the issues surrounding infrastructure credits. Whilst Rule 34(b) provides greater clarity on when infrastructure charge credits apply, there remains a lack of sector-wide consistency. Moreover, certain companies offer credits based **on what they believe is appropriate whilst some offer no credits whatsoever**. Company obfuscation is often applied as a defence to deter developers from persisting with a claim for legitimate IC credits. Given the construct of Rule 34(b) and which has remained consistent despite amendments to the charging rules, there are credible arguments that certain companies in withholding the payment of legitimate infrastructure credits have therefore used the redevelopment process to cross-subsidised existing customers. The quantum involved is conservatively estimated to be considerable and therefore we would welcome Ofwat's comment and/or steer on its' intentions regarding this matter before advising clients to consider recovery either through the formal determination process or by other means.

- Network Reinforcement – shouldn't this be included?

- 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 especially 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. How will this deduction be treated alongside sewerage infrastructure charges, i.e., a 50% reduction in the sewerage IC if there is 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. (Water stress area perhaps needs its own definition). Moreover, some water companies ask for verification of water use before actually committing to a deduction – procedurally, how is this to be managed given developers have no control over post-occupation per capita water consumption. **Ofwat should make it quite clear that post-occupation verification of water use is not required.**

- 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? What influence do these building typologies have when crystallising infrastructure charges? In short, no one knows.** Moreover, annual company accounts do not provide sufficient detail in this regard. Our view and that of our clients 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 into 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.

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 (and before) 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 subsidises 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.

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(1) Section 37 WIA 1991 – General duty to maintain water supply system: It shall be the duty of every water undertaker to develop and maintain an efficient and economical system of water supply within its area

(2) Section 94 WIA 1991 – General duty to provide sewerage system: It shall be the duty of every sewerage undertaker to provide, improve and extend such a system of public sewers and to so cleanse and maintain those sewers as to ensure that that area is and continues to be effectually drained ….

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.

In our response to the Ofwat consultation that closed on 8th June we provided a copy of an Independent Paper identifying several shortcomings in terms of how network capacity and therefore any network reinforcement is assessed/determined. This is particularly relevant when considering existing foul sewer networks. **(The recent Novartis determination and which saw Southern Water having to return over £500k to a major House builder, provides unequivocal corroborative evidence – more determinations in this regard can be expected).**

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.

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. With this in mind, we would suggest the following process would greatly assist in undertaking any reconciliation, in addition to providing much needed transparency:

- 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 will not be stalled.

- The statutory duties imposed on all water and sewerage companies, as referred to earlier, 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

(3) Statutory Instrument SI 2012 No 767 and which defines water and sewerage undertakers as ***"specific consultation bodies"***

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 and one applied by almost all UK businesses – why should the water and sewerage sector be any different. It is also an essential requirement for any business when auditing annual company accounts.

3. CONCLUDING COMMENTS

This consultation is all the poorer for not having included the SIA-Partners Report, especially given the material importance Ofwat has attached to the report. Moreover, fundamental principles requiring resolution remain, but we can only begin to tackle these by working collaboratively and recognising the Developer Community is not only a key customer but one that has considerable experience and expertise to offer. That said, more substantive work is required if we are to achieve each of the aspects defined by Defra in the statutory guidance issued in January 2016.

Through the proposed revision of its charging rules Ofwat is well positioned to ensure water and sewerage companies disclose far more detailed, cost-related evidence and information. If Developer Community concerns are to be dispelled and the underlying principles set down by Defra 5 years ago are to be met, this opportunity should not be passed up.

In terms of the staggering disarray in company costs and charges, at the request of our clients, in April 2021, after disclosure of each companies costs and charges for 2021/22, we undertook an inter-company review of mains costs – with client consent, a copy of the resultant schedule has been disclosed as part of this response – see Appendix 1. **We believe Ofwat will agree that for one company to be allowed to increase its mains cost by a staggering 355% in just two years is wholly unacceptable.** Likewise, the underlying level of increase(s) in other companies that far exceed the underlying level of inflation. We would venture to suggest that this **may well be one of the unintended consequences of a light touch regulatory approach.** The earlier evidential gaps in company charges as identified in the schedule are also noteworthy.

We would welcome Ofwat's comments on the evidence presented and whether this readily identified disparity in costs will result in Ofwat targeted intervention.

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