Fair Water Connections

Seeking fairness for self-lay providers

August 2022

Response to Ofwat Consultation on Their Methodology for PR24
– With Developer Services Focus

Fair Water Connections supports Self-Lay Providers (SLPs) operating across England and Wales. This response, which concentrates on Appendix 3 (Developer Services matters), gives our views on the proposals Ofwat has shared about how they intend to structure their PR24 methodology.

Given that Ofwat is stating that they:-

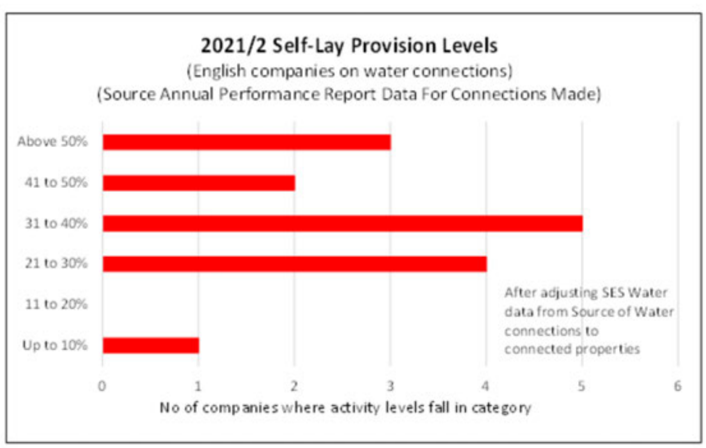
- are focusing on the long term; and,
- want to deliver greater environmental and social value; and,
- wish to reflect a clearer understanding of customers and communities; and,
- want to driving improvements through efficiency and innovation.

We are disappointed that their Developer Services intentions for PR24 look, to us, to be mainly ‘housekeeping’ orientated and not striving towards greater achievement of best practice competitive delivery. To our members this is very much a missed opportunity and fails to deliver against the Defra direction to “make markets work” or to better facilitate the housing growth the Government is expecting companies to help achieve.

So, in addition to responding to the consultation questions we also set out below how a more forward thinking approach could better deliver for developer customers and help achieve the objectives Ofwat have set themselves for PR24.

1. Position Statement – Where is the competitive water connections market?

Whilst progress with establishing connection competition across all companies has taken time there is now, based on the latest Company Annual Performance Report data, a real sense that alternatives to company developer service provision are, mostly, getting well established.



The latest data, summarised above, show that there is just one company who is lagging behind the year on year steady improvement. This surely means that PR24 proposals need to be set around where it is envisaged that the market will be in 2025 (and not on backward looking historical positioning). So, to us, it is important that Ofwat now clearly signals where they both expect competitive connection take-up to be by 2025 and set out their aspirations for the PR24 period. Companies can then use the run-in period to develop their own strategies for closing any gaps, particularly on their pre 2025 positioning. This being done in much the same ways as they are now doing working through preparation for the removal of Income Offsets.

2. Water Connections Not a Single Market Entity

Although the bulk of new water connections are to new houses on development sites, so require mains in addition to service connections, it unreasonably simplifies the situation to regard the provision of new water supplies as a single market entity. Instead, needing to be separately considered, are both 'one-off' supplies from existing mains to infill/stand-alone developments and larger than standard sized connections where multiple new properties, typically flats/apartments, are supplied through shared private pipework. Each of these market sub-segments being much less attractive to competitive providers because;-

a) the volume of work on which to secure a return is relatively small; and,
b) there are entry barriers as, until a market presence is established, the operating costs per connection are much higher; and,
c) a significant proportion of each connection is work in the highway which is often classed as 'non-contestable' and where it can be done the highway noticing/one-off street work opening permit costs are much higher than those company incur when they do the work themselves.

Innovative thinking regarding allowing SLPs to use company road opening arrangements (after all the same work that they, or their contractors, would do themselves ends up as being adopted) could alleviate these issues but, in all probability, there will remain an on-going divide between work that is attractive to competitive providers and that being left to be done by companies (as the provider of last resort).

However, Ofwat needs to recognise that by formally splitting the water connections market into sectors, one which they expect to attract competition and another which will not, they are signalling that a market divide being maintained is reasonable and thereby surely foreclosing on company willingness to look at what is necessary to make individual connection provision more attractive to SLPs (and others).

3. Connections v Properties

As discussed above it is routine for multiple property developments to be connected through a single, or a number of shared, connections. This means, particular where companies supply large urban conurbations, for the number of connected properties to significantly exceed the number of actual connections installed.

From the 2021/2 connections data some 33,500 (or 20% of the total) more properties were supplied than the number of connection installations. These, for the reasons already given, are invariably multiple supply connections predominately installed by incumbents themselves.

Our view is that drawing on both connection and property volumes confuses understanding of the water connections market (and it appears that Ofwat themselves have used wrong labels in their illustrative data in Appendix 3). We are therefore of the view, because it better reflects market dynamics, for all market share comparisons to be solely done on the basis of number of connections made.

This however requires a sound definition (noting that neither 'connections' or 'properties' are currently specified in the Connection Rules documents), especially whether it is the site or the application numbers that are the determinant (i.e. when a site of 36 units is called-off by a developer in 6 separate applications of 6 units is the 6 or the 36 used to control the classification?).

We also note that whilst 40% of connections (as stated by Ofwat but thought by ourselves to be nearer 25%) maybe on sites which do not require new mains these are not evenly distributed across companies. So applying such a cut-off on companies, especially those serving more rural areas, will invariably unreasonably restrict their thinking towards competition.

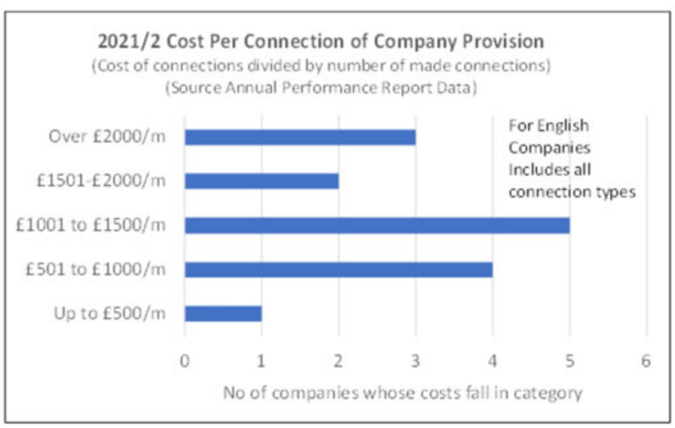
4. Market Segmentation

Whilst recognising that some divide between what is expected to be a contestable market and where company provision dominates our view is that the proposal to make this split at 25 Properties is unduly cautious. Instead, we consider that any split should be based on whether the development requires mains or can be directly served by connections off existing mains. This, to us, would be much simpler for companies to operate and should not deter companies from widening their thinking on the 'mains' work types that they permit as being 'contestable'.

If however Ofwat is minded to make the 'restricted' category larger we propose that the divide should be set at 10 connections. This is because the data in Ofwat's Table 3.2 looks to supports this (once consideration of the above property v connection discussion is considered). It also is more strictly tied to applications that do not require mains whereas a higher cut-off would allow much greater overlap (and be more difficult for companies to operate).

5. Cost As A Determinant

A factor which only gets a passing mention in the Ofwat consultation document (where it is merely alluded to by a NAV quote) is the impact of low company charges on stifling competition. But our company worked example costing analysis, which has already been shared with Ofwat, shows that there is a close correlation between those companies whose terms on the specified worked examples are the cheapest and those which have the lowest levels of competitive uptake.

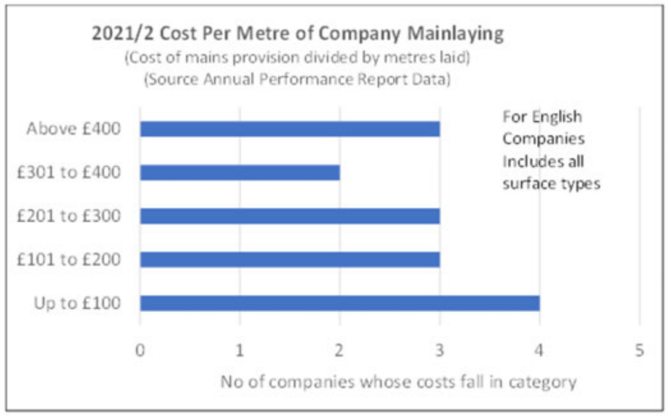


Company worked examples combine both mains and service provision costs but considering both separately, and using both the volume and cost data provided by companies in their Annual Performance Reports, the cross company comparison shows a wide range of costing differences. These are summarised in the accompanying charts for both service connections and mainlaying.

Low company charges however do not necessarily mean there is no competition but invariably results in competitive providers deciding which particular types of development are worth them considering. This placing a cap on competitive provision when compared to best practice elsewhere.

Whilst recognising that our evaluation is somewhat crude (as it does not factor the impact of self-lay work when mapping company volumes against their costs) it highlights to us wide cost variations. Hence, we cannot see that Ofwat's Charging Rule principle of charges needing to reflect the costs of the relevant service is being universally honoured.

What our own analysis highlights is that the companies with the lowest charges look to be just recovering the costs of a proficient sub-contractor. So just direct labour and material costs and not the overheads necessary to include contractor mobilisation and contract management. This is backed up by the SIA Partner findings, in their 2021 Connection Charge Root Cause Analysis for Ofwat, where they found that only 5 companies included a separate contractors overhead element in their costs. This omission, where such overheads are not being built into the rates, is likely to be resulting in some companies not recovering all of their connection works costs. As this looks to be a continuing situation in those companies who charge the least we are surprised that, in the interests of fair and open competition, Ofwat has not (apparently) sought to do any more than ask for data on how companies build up their customer charges.



From a self-lay community perspective free and open competition requires all provision costs (so Tier 1, 2 and 3 in a contract hierarchy) to be appropriately allocated across work activities. As a customer group, without having access to company financial transactions, we can only highlight our perception of what is happening. But this is backed up by our SLP members having detailed knowledge of all construction costs, including the sort of overheads that are necessary to cover contract management and work allocation/supervision.

Given its recent introduction Ofwat appear to realise the importance of compliance against the charge reasonableness principle for a viable competitive connection market to function but, despite the highlighted costing variances Ofwat are yet to demonstrate any willingness to intervene. Our view is that by allowing a situation whereby certain company charges look unreasonably low to continue Ofwat is materially holding back competition and therefore limiting any aspirations they may have for the development of connection competition during the PR24 period. This means that the installation choices available to the developer customer group will be restrained as they are being denied, by regulator inactivity, the benefits that fully functioning connections markets would offer. But targeted Regulator intervention now could materially change this and lead to a very different market situation in time for the PR24 review period.

5.1 Proposals for Pricing Controls when competitive take-up is minimal

Given our view that the amounts being charged is a major factor in holding back competition in those companies with the lowest charges we view it as nonsensical that Ofwat should propose (as a penalty on poor performing companies) restricting price increases to only allow developer charges to increase in line with CPIH. This is because holding down costs would surely only make the ability of alternative providers to compete worse.

Instead, our proposal is that low competitive take-up should automatically trigger an Ofwat investigation whereby they consider if the company concerned is fully recovering <u>all</u> their costs and the appropriate overheads. Also, that their contracts are not structured in ways whereby contractors receive performance bonuses which are not recovered through developer's charges. Should under recovery be detected then the companies should be fined an Ofwat determined penalty and made to set their charges at the required (full cost recovery) level.

5.2 Handling Inflation

The current unprecedented, over recent years, inflation levels are being differently experienced by companies and competitive providers. It also looks as though many companies have set their current years charges based on inflationary catch-up at the end of the last year rather than forecasting their envisaged costs over the year ahead. To counter this situation continuing there is a need for Ofwat to ensure that companies now fully factor inflation forecasting into their annual charge settings.

Moreover companies, with ongoing multi-year contracts covering labour and materials, with pre-determined cost increase limits, are largely protected against cost rises in ways which competitive providers do not enjoy. Looking ahead this situation may get re-balanced around 2025, when many company contracts will get renewed, but the harm currently being caused to competitive provision needs to be recognised and tackled by Ofwat. Also, Ofwat needs to introduce safeguards whereby companies cannot simply carry forward their current suppressed costs (i.e. below the current costs on a new entrant) into their PR24 thinking.

6. Ensuring All Costs Are Captured

We are concerned that Ofwat's intentions regarding categorising work as either 'in' or 'out' of the price control mechanism looks to be somewhat of a 'housekeeping' matter unless Ofwat become much stricter on ensuring that all Developer Services costs in a defined market are captured in ways which prevents cross subsidies from other company activities happening. We raise this because the current wide ranging cross company charge variation can, in our view, only be happening if either charges are not reasonably reflective of costs or costs, particularly (as discussed above) those relating to overheads, and are not being recovered in ways that are fairly proportioned across all contract activities.

Examples where we can envisage under, or over, overhead recovery happening are where a Developer Services activity relies on another company department to do elements of the work and cost pass-through is being done somewhat arbitrarily. Also, if uplift on contractors rates is applied as a small percentage on all contract work rather than reflecting the disproportionally higher costs of managing relatively small work tasks for Developer Services (in contrast to major mainlaying projects).

So, to us, it is not where Ofwat chooses to position certain Developer Services activities from a regulatory stance that is important but how assiduous they are in ensuring that the across departmental activities necessary for company Developer Services delivery do not create internal cross subsidies which harm connection competition. To date we are not seeing this matter, which is of great importance to our members, being picked up by Ofwat.

7. D-MeX Considerations

We note that Ofwat does not appear minded to change D-MeX for the coming regulatory period. To us this is somewhat bizarre as the various measures, both quantitively and qualitative, are heavily skewed towards performance in the sub-sector Ofwat is proposing to create around water connections to small developments. So Ofwat looks to saying they wish to encourage greater competitive water connection take-up but (effectively) will be rewarding performance based on delivery in a subsector which they recognise will be dominated by company provision!

Moreover, by continuing to reward successful companies (or penalise poor performers) by a multiple of their Developer Services turn-over the D-MeX mechanism is, in its self, structured in a way that deters competitive provision. This is because the more revenue a company loses (through work transferred to be done by SLPs) means that the potential reward is correspondingly lowered.

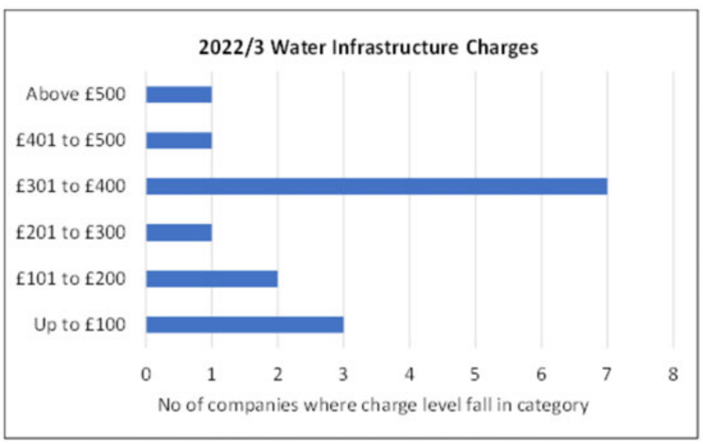
So whilst we doubt Ofwat is minded to address the disproportional anomaly from limited competitive feedback being somewhat marginalised in D-MeX outcomes surely a fair means is needed to determine rewards based on total activity volumes and not just the proportion of work companies retain themselves. We do however recognise that low levels of competition does mean poor performing companies incur proportionally higher penalties but (experience to date shows) this does not drive the sort of improved responsiveness SLPs are seeking (as delivery to SLPs is not the sub-sector which materially changes the D-MeX outcome scoring!).

8. Network Reinforcement

Developer Services related network reinforcement is work necessary to company systems to ensure that they can adequately supply new developments without detriment to existing customers. The English Connection Charging Rules now providing a pragmatic split between what is deemed 'site specific' work and that classified as 'reinforcement'. With the 'reinforcement' element being recovered through 'Infrastructure Charge' payments.

From a SLP perspective 'reinforcement' work is invariable not viewed as contestable and the Infrastructure Charges payable are fixed regardless of who does the connection work. But whilst this element of charging is more a matter for developers we do make the following observations.

Given that the impact of new development on existing infrastructure, assuming it to be well managed, must surely be similar we are struck by the variability in the amounts companies charge. As shown in the chart below this ranges, for 2022/3 (across English companies), from no charge (so a company saying that growth can be supported without any investment) to £633 per new unit. By PR24 charging in accordance with Ofwat Rules will have been in operation for more that 5 years so our expectation is that any historical reinforcement shortfall should have been addressed. We therefore feel that Ofwat should, for PR24, have a mechanism whereby the current variability in network reinforcement related charges is much reduced.



Additionally there is a potential disconnect between companies (quite understandably) encouraging developers to factor reducing water consumption in their new home design and continuing to charge for network reinforcement works on the basis of historic consumption levels. This invariably means that developers are both paying for various in-property water saving features and funding system enhancements beyond that needed for actual envisaged demands. So Ofwat needs a means whereby companies demonstrate that any 'environmental discounts' they apply are directly linked to reinforcement cost savings.

As developers (and those who provide water services to them) have no means to challenge Infrastructure Charge amounts Developer Services customers have to look to Ofwat suitably regulating reasonable network reinforcement works and associated costs. Whether this is through having reinforcement in the network plus price controls at PR24 is a matter for Ofwat but they need to recognise that the sector needs greater regulation of Infrastructure Charges such that customers can be assured that what they are paying is reasonable.

9. Responses to Ofwat's Specific Questions

Overview comments

In many ways our SLPs members are indifferent to how Ofwat chooses to regulate the connections sector. Whilst Ofwat may consider that their various proposals are necessary we view them more as 'housekeeping'. So we are additionally looking for Ofwat to show vision about where they want companies to move competitive connection provision to by 2025, and then during the PR24 period.

Based on reports for 2021/2 we applaud those (two thirds of) companies who already show that self-lay provision is over 30% of all their water connections and can see others moving, year on year, to get towards this position. Sadly all companies are not in this position and Ofwat needs to recognise that action is needed to address where low company provision charges are a major factor in deterring competition. To us this needs doing well before PR24 such that a 'level playing field' across all companies gets established. Furthermore Ofwat should now clearly signal where they expect competition provision, against the already established best practice companies, to be by 2025 such that companies can actively seek to use the next 2 years to, accordingly, position themselves.

Q1. Do you agree with our proposal to include network reinforcement in the network plus price controls at PR24?

We are ambivalent about where Ofwat chooses to position regulation of network reinforcement work. More important to our members is ensuring that:-

1. The amount being charged is closely aligned to the reasonable costs of the associated necessary work; and,
2. Companies are restricted to only install works which align with the various reduced demand/ environmental discounts they offer.

So, on behalf of our members developer customers, we are looking for greater control on what companies decide is 'necessary' network enhancement (and therefore they are free to charge) and for companies to demonstrate that as water usage in new homes reduces so does the extent of company determined reinforcement works.

Q2. Do you agree that the inclusion of network reinforcement in cost sharing would be enough to manage uncertainty around the volume and mix of network reinforcement work to be delivered?

We are surprised that companies have difficulty aligning their forecast predictions of necessary work with what they eventually promote. This is because companies have, across regulatory review periods, had to factor growth from new development into their spending plans so why is it now proving difficult?

Hence we are unsure the inclusion of network reinforcement in cost sharing would make any difference. What, in our view, is necessary is much stricter Ofwat controls on this work stream to only pass onto developers what are reasonable, and fully justifiable, costs.

Q3. Do you agree with our proposal to remove wastewater site-specific developer services from the wholesale wastewater network plus price control?

We are not commenting on this proposal as our concerns are centred on water provision connections.

Q4. For water site-specific developer services:
a) Do you agree with our proposal to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24, but with transitional arrangements for companies with low levels of competition?
b) Do you think that new developments of 25 properties and below should remain in the wholesale water network plus control or be removed? If they were removed from the price control, what alternative protections could we introduce to protect developer services customers from potential monopoly power?

Although recognising that there may be an argument for a split between how smaller developments/ one-off water connections and larger developments are handled from a regulatory perspective we do not support the Ofwat proposals. Primarily this is because it is saying that a certain proportion of work is always going to remain non-competitive and our view is that Ofwat should be dealing with the root causes of why this is currently the case rather than tackling the consequences.

If Ofwat is minded to introduce a split our strongly held view is that it should be made on the basis of 'connections' and not 'properties'. This is because, especially in urban areas, multiple properties can be connected to a shared connection (with the on-site pipework to each unit being done by plumbers). So it is more meaningful to focus on the primary activity – which is 'connection' volumes.

Furthermore, a pragmatic approach would be to make any split on the simple parameter of whether the supplies do, or do not, require mains. This being reasonably easy to operate. But if Ofwat is minded to base the divide on the size of development we view 25 units as being somewhat pessimistic (given how competitive provision workloads are generally moving). Our counter (if necessary) proposal (which looks to be supported from data in Ofwat's Table 3.2) would therefore to make such a split at 10 connections.

As regards a transition (when a company has low competitive provision levels) our view is that Ofwat:-

a) Now needs to clearly signal where they expect companies to be by 2025 (so that they can take the necessary steps, in the time currently available, to reposition themselves); and,
b) Move completely away from any situation which would retain low pricing as, where this exists, it deters competition (as already demonstrated in activity volumes). So we discount any thoughts on restricting charges increases to CPIH criteria. Instead we maintain that Ofwat needs to step in and evaluate whether low charges are cost reflective (of all elements including overheads and internal recharging) in such companies and appropriately financially penalise them.

Furthermore Ofwat needs to set out how inflationary pressures are to be handled by companies in ways which counter market distortion caused by company's buying power enabling them to benefit by securing long term contracts with inflationary increase limits when competitors experience much higher 'spot'/ direct purchase costs. This being a significant new factor which is increasingly impacting on competitive connections provision.

In relation to where the regulatory control is positioned our view is that this is somewhat of a 'housekeeping' mater for Ofwat to determine with companies. Instead our members urge Ofwat to prioritise ensuring that the water connections market fairly functions so that they can compete on a 'level playing field'. For this to happen Ofwat needs to recognise that company Developer Services do not operate in isolation and rely on internally provided services from many other company departments. For the cost of this support to be fairly applied to connection charges the internal journal transfers need to actually reflect all associated costs and contract overheads applied in ways which do not cross subsidise Developer Services work from other, more major, contract works.

Our own analysis of certain company's charges indicates that full capture of costs does not always necessarily happen and this can result in situations where charges only represent typical subcontractor payments without the overheads that arise when contractors schedule and plan Developer Services work. This issue being picked up by SIA Partners in their 2021 Root Cause Analysis report for Ofwat and where this is continuing under recovery arises it is materially harming competition. Therefore Ofwat will need to be much more prescriptive about what cost elements are to be included in whatever 'ring fenced' cost basket they decide to introduce.

So, if Ofwat feels that moving activities outside various 'price controls' would aid their policing of what company costs are applied to connections work we support the proposal. However, to our members, it is the Ofwat 'policing', to tackle the all to apparent current unfairness in certain company charges, which is important as, without this, any regulatory change would look to serve little purpose in aiding fair and open connections competition.

Q5. Do you have any views on any other aspect of our developer services proposals in this appendix?

As outlined in our preceding comments above we maintain that Ofwat needs to recognise where best practice in competitive provision is happening and to widely signal to those companies not so positioned that they need to take steps to reposition themselves. This is because, although various historical factors have influenced this position, companies have now surely had adequate time to deploy the Charging Rules and Adoption Code to ensure that fair and open connection competition happens (by 2025) in their areas.

For best practice to be widely deployed by 2025 this however required Ofwat to actively investigate those companies whose own charges are low and where competitive provision volumes are significantly less than others now achieve. This requires much more from Ofwat than merely collecting data and hoping that generalised feedback will stimulate companies to change their stance on connection charging. They also need, either in themselves or through the consultants they use, to better demonstrate their understanding of market dynamics and the factors which harm competitive provision.

Aligned with ensuring there is costing comparability between the provision options there is a need for Ofwat to state inflationary provision expectations. This to be done in ways which prevents competition from stagnating whilst companies enjoy the benefits of the various cost control protections, inbuilt into their current labour and material contracts. If unchecked this will invariably lead to a stepped price increase change when contracts get renewed (around 2025?) which could create market responsiveness difficulties if SLPs are unable to quickly respond to the work volumes fairer pricing brings. A relevant factor here being the lack of progress in tackling allowing experienced company operatives to move to work for SLPs without significant training and registration costs being incurred.

A further factor we flag to Ofwat is the impact that the way that the structure their D-MeX mechanism has on encouraging companies to concentrate on company provision. This arises because the scores are heavily weighted to one-off connection provision and rewards are sized based on company revenues (which are kept high when competitive provision is low). This must harm market provision and is surely not the signal Ofwat wishes to portray.

Prepared By

This submission has been prepared by:-

[redacted],

Fair Water Connections Managing Coordinator.

Please contact Martyn should any further information or clarification to the above comments be thought helpful. Also if there is a wish for further discussion to address, from the self-lay community perspective, the identified shortcomings in the Ofwat proposals.

Martyn can be contacted:-

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