OFWAT CONSULTATION: METHODOLOGY FOR PR24

RESPONSE TO APPENDIX 3: DEVELOPER SERVICES

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

We are sorry to say we do not.

Ofwat's proposals appear to be aligned to making charges reconciliation as simple as possible for water and sewerage companies whilst denying developers the right to see where, when and how water and sewerage infrastructure charges have been invested.

Cumulatively, this income stream is close to £100m per annum and since sector privatisation represents a cumulative income stream of c.£2.80 billion.

Furthermore, as part of the reforms introduced from 2018 ICs supposedly include contributory payments for in-consequence network reinforcement. If ICs are not to be perceived as an opportunistic tax on new development, then a detailed audit and disclosure of this revenue stream and associated expenditure, as originally promised by Ofwat, must be seen to be more stringent. It also remains an integral part of any business practice.

Moreover, such qualitative and quantitative disclosure would greatly assist Ofwat to secure more robust cost and charges evidence to inform their charging rules.

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?

No – see previous answer.

In our view Ofwat's approach to network reinforcement is too casual to make any meaningful (positive) difference.

It is quite clear Ofwat has little appreciation of the plan-making process, despite water and sewerage companies being statutory consultees at the local/strategic plan stage, coupled with a 5-yearly review of each company's business and investment plans and forecasts. In our view, before making any effective decisions and or recommendations/proposals in respect of PR24 Ofwat must first gather far more robust evidence.

At present, the approach to PR24 reads as mere tinkering around the edges.

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

No

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?

Setting a benchmark of 25 dwellings is contrary to the established definition of a small site, i.e., 10 dwellings, as accepted by Defra and DLUHC. To avoid introducing further confusion, if not complexity, why not set the bar at 10 dwellings? This would also assist increased competition from SLPs.

As for the second part of the question, before any directions for PR24 are crystallised we would expect Ofwat to first undertake a detailed investigation of the so-called typical charges. On page 16 of the consultation, Ofwat state the following:

> ***"SIA Partners found there is wide regional variation in the level of connection charges for the same hypothetical development. For example, typical charges for a 50-house development ranges from £39,216 to £147,590."***

The significant cost variation identified by consultant SIA Partners (retained by Ofwat) is entirely consistent with the analyses undertaken by developers for the past 4 to 5 years as well as the Gray Review in 2011.

This evidence has been disclosed to Ofwat by developers but largely ignored. In our view, and that of many of our developer clients, determining a typical charge is simplicity, namely, a review of labour, plant, material and overhead costs. (*Connection charges are not meant to include a profit element*). However, Ofwat continues with its reluctance to instruct companies to provide the necessary granularity and continues to speculate why there is such significant variation.

If predictable costs are to be provided by companies, they must be first accompanied by transparent and robust evidence disclosure. PR24 should make this a compulsory, annual requirement.

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

The nexus of the PR24 methodology reads as nothing more than an exercise in routine housekeeping for the water and sewerage sector. It is difficult to understand why Ofwat are seeking to remove 32 years of funding from developers in relation to income offsets and failing to understand the value developers give to companies in perpetuity of new infrastructure asset that the companies obtain a revenue from and enhanced benefits on their balance sheet in being able to borrow more capital. **In many instances this will involve developers losing between £700 to £1,000 per plot from 1st April 2025**.

If effective decisions are to be made, they must be accompanied by the necessary robust evidence – this basic requirement is still missing and on several counts.

There can be no better example than the DSRA which must be one of the most ill-conceived ideas ever devised by any form of regulator. To remunerate the companies for doing nothing on the premiss that it will stop them from completing so SLP's and NAV's will get their market share and to quote the consultation: -

"The revenue adjustment is neutral to which party delivers the services. So, incumbent water companies can benefit financially from connections completed by others because their revenue is unaffected, but costs are avoided."

So, the monopoly commercial companies cannot lose whether they do a connection or do not make a connection is tantamount to manipulation of a competitive market by a regulatory. This becomes even more farcical in that Ofwat have been vocal in saying how they have been successful in stimulating competition since 2020. **For the companies to be paid not to compete but still get the same element of income is a really perverse form of economics.**

Until there is much improved evidence/data granularity Ofwat's approach to PR24 is unlikely to increase competition, whilst continuing to raise questions about the monopoly position occupied by water and sewerage companies, especially when it comes to costs and charges that are considered anti-competitive.

In addition, there is no indication that water and sewerage company term contractor terms/provision and especially costs are representative of value for money. Neither is their evidence of their having undergone robust audit. For example, sewerage infrastructure constructed by developers is often provided at a much lower cost than the sector's incumbent contractors – a difference close to 100% is common.

In summary – much improved cost granularity must be a principal requirement before PR24 is crystallised by Ofwat. It cannot be right that income offsets are not being paid to developers from 1st April 2025 and that Ofwat have changed Defra's Principles by removing the balance of charges. **The concept of income offsets has been in place before and since 1989 and was to provide developers**

with some recompense due to them providing companies with infrastructure asset which delivers a revenue in perpetuity to the companies who are commercial organisations. There is also the added bonus of the advantages of posting assets on the balance sheet which facilitates the ability to borrow more capital. Why is this not being considered by Ofwat anymore?

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RESPONSE TO APPENDIX 9 (QUESTION 8) – SETTING EXPENDITURE ALLOWANCES

The major concern expressed by our developer clients arises from the following Ofwat statement:

> ***"We propose to allow funding through the price review if water companies are required to go beyond environmental requirements due to nutrient neutrality in England. We would expect developers to pay the full costs for any nutrient mitigation."***

In our view and that of our clients this is wholly unacceptable and ignores the statutory duty imposed on all sewerage companies pursuant to s94 WIA 1991 and upheld in the Supreme Court decision handed down in 2009 (Barratt versus Welsh Water) – paragraph 23 of the decision being of particular relevance – see below:

> ***23. The right to connect to a public sewer afforded by section 106 of the 1991 Act and its predecessors has been described as an "absolute right". The sewerage undertaker cannot refuse to permit the connection on the ground that the additional discharge into the system will overload it. The burden of dealing with the consequences of this additional discharge falls directly upon the undertaker and the consequent expense is shared by all who pay sewerage charges to the undertaker. Thus in Ainley v Kirkheaton Local Board (1891) 60 LJ (Ch) 734 Stirling J held that the exercise of the right of an owner of property to discharge into a public sewer conferred by section 21 of the 1875 Act could not be prevented by the local authority on the ground that the discharge was creating a nuisance. It was for the local authority to ensure that what was discharged into their sewer was freed from all foul matter before it flowed out into any natural watercourse.***

This remains an important precedent whilst the position taken by Ofwat that developers are responsible for nutrient mitigation is misaligned for a fundamental but simple reason, namely, **it is the occupier of a home/premise that creates wastewater discharge not the developer.**

Moreover, these occupiers are paying for effectual wastewater treatment as part of domestic/commercial water and wastewater billing arrangements with water and sewerage companies. This principal fact has not been recognised in Ofwat's proposals.

In addition, in November 2021 and in subsequent correspondence with Natural England, a number of serious flaws with the Natural England calculation methodology were raised directly with both Defra and Natural England. As yet, there has been no response from either, but the flaws remain. In our view and that of our clients, the calculation methodology requires more detailed evidenced-based scrutiny which should be undertaken as a matter of urgency, i.e., before Ofwat's PR24 proposals can be finalised.

In Mid-July 2022, the following formal EIR/FoIA request was made to Ofwat – it is considered to be of significant importance:

1. ***Since sector privatisation in 1989, what steps has Ofwat taken to ensure sewerage companies meet their s94 statutory duties in response to the progressive changes in environmental legislation (both EU and domestic) and specific to the effectual management and control of all WwTWs, especially the statutory obligations relating to treated effluent quality?***

2. ***What level of Sewerage Company related capex has Ofwat sanctioned/approved as part of the AMP process to meet these progressive obligations?***

3. ***If compliance exemptions were deemed appropriate what legal justification supported such decisions?***

The above questions relate specifically to the following progressive changes in environmental legislation, and which had and continue to have a direct bearing on the s94 statutory duty imposed on all sewerage companies in terms of effectual wastewater treatment and treated effluent quality standards:

- ***July 1989 – Water Act 1989***
- ***May 1991 – Urban Wastewater Treatment Directive***
- ***July 1991 – Water Industry Act 1991***
- ***July 1991 – Water Resources Act 1991***
- ***December 1991 – Nitrates Directive***
- ***May 1992 – Habitats Directive***
- ***November 1994 – Urban Wastewater Treatment (England & Wales) Regulations 1994***
- ***December 2000 – Water Framework Directive***
- ***December 2006 – Groundwater Directive***
- ***2006 - Bathing Water Directive***
- ***April 2010 – The Conservation of Habitats & Species Regulations***
- ***May 2014 – Water Act 2014 (s22 & s23)***
- ***November 2017 – Conservation of Habitats & Species Regulations 2017***

In the context of nutrient neutrality these are crucial questions and for compelling reasons. It has remained incumbent on any regulator/government body to ensure sewerage companies were; (a) alerted to the changes in affecting environmental

legislation, especially WwTW treatment standards and effluent quality, and (b) provided with the necessary capex in response to these changes.

There is a considerable groundswell of concern that before Ofwat contemplate saddling developers with further costs that are neither justified nor reflective, they should first ensure that sewerage companies discharge their statutory duties, especially those pursuant to s94 WIA 1991.

Moreover, Appendix 9 provides no indication as to how any developer contributions would actually be determined on a fair, proportionate and representative basis.

In addition, Ofwat's proposals appear to be in direct contradiction of the recent Ministerial Statement with Ofwat having stated in Appendix 9:

> ***" …. any improvements to WWTW will not be available to housebuilders to count towards mitigation."***

Therefore, and from Ofwat's perspective, in the short-term this option will not be available.

Moreover, in the longer term, developers will effectively be being taxed for something that is the solus responsibility of sewerage companies. Furthermore, there is no indication that as a consequence of this proposal Ofwat will reconsider either the principle and/or quantum associated with sewerage infrastructure charges.

SUMMARY

In the round, Ofwat's proposals do not go far enough when it comes to meeting the requirements and expectations of Defra. In November 2017, Defra was unequivocal in what it expected the reforms that were to be overseen by Ofwat would achieve:

> ***"The government has certainly made it clear in its strategic priorities and objectives for Ofwat that it expects that companies will contribute to increased house building by achieving timely connections of new developments to water and wastewater systems."***
>
> ***"We have asked Ofwat to keep under review what it can do to make sure that company planning, and delivery keeps pace with housebuilding and supports development across the country."***
>
> [Underlining for emphasis. This is a key statement in the context of the present paralysis with housing delivery (120,000 homes delayed and rising) due to Natural England's standing advice concerning nutrient neutrality and affecting 74 Local Planning Authorities].
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> ***" … the range of initiatives underway are intended to improve the developer service experience by providing improved customer service, increased competition, more choice and transparency in the market. These in turn are expected to lead to cheaper, better and more innovative services for all developers."*** **(Sarah Hendry Director, Floods & Water Defra – letter dated 7th November 2017)**
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> At a time when the commercial vitality of house builders and developers is being threatened by excessive cost increases, (and a market that is rapidly 'cooling') Ofwat's latest consultation represents another exercise in 'mission creep' and one objectively seeking to rely on the developer community as a proxy for maintaining if not enhancing the commercial interests of the water and sewerage sector.
>
> Likewise, it has become a means of potentially cross-subsidising existing customers - for example, by the removal of income off-sets. This latest consultation appears to overrule long-established legislation/statutory guidance to favour a monopoly utility provider lacking in cost transparency, qualitative and quantitative supporting evidence, and a robust audit mechanism. In essence,
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> Ofwat has introduced a series of weaknesses that populate a regime they [Ofwat] are responsible for creating. Moreover, attempts to justify what has emerged by labelling the process as a complex area of customer charging is anathema to the simplicity that existed prior to the April 2018 reforms.
>
> Ofwat are responsible for making what was a simple process far more complex than it needs to be. Moreover, the ability to challenge Ofwat has been progressively diluted by their Inherent indifference when it comes to

their taking cognisance of important developer customer input and feedback.

As for Ofwat's proposals relating to nutrient neutrality these are wholly unacceptable for the reasons articulated in our response.

Moreover, Natural England's calculation methodology remains counter-intuitive to one of Ofwat's key PR24 proposals, i.e., the so-called environmental discount for reduced water consumption in new housing. This lack of synergy/joined-up thinking is unhelpful and only serves to introduce greater complexity in addition to being manifestly inequitable. Hence the justification for an evidenced-based review/audit of the Natural England nutrient calculation methodology as a matter of urgency.

When considered in the round the reforms introduced and overseen by Ofwat have clearly resulted in a charging regime that has had significant and adverse cost repercussions for house builders and developers – in some instances to the point of seriously compromised project viability.

In essence, for gifting assets to water and sewerage companies that are income generating in perpetuity, there are now no reciprocal financial mechanisms benefitting the developer community. In our view and that of many of our clients, PR24 should be the start of a process that replicates what happens in Scotland where these assets are paid for by the water and sewerage company.

We are not confident that the concerns and comments articulated in this response will be considered by a regulator that gives the impression that it has already decided the outcome of any consultation. That said, we remain more than willing to engage in further dialogue and to share the evidence supporting our response with Ofwat.

September 2022