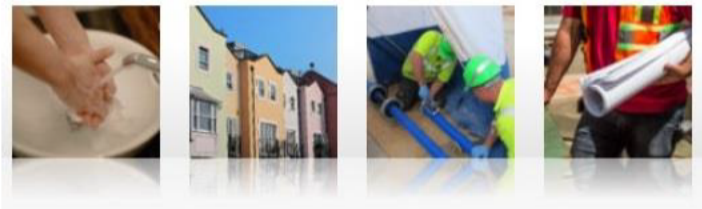


Response to consultation on Changing Ofwat's charging rules to support the new developer services framework

For over a decade Fair Water Connections has been to the fore in lobbying for the interests of Self-Lay Providers with both Ofwat and companies themselves. My previous work experiences, linked with heading Fairwater Connections, has giving me extensive experience of the water connections market. This includes related competition and understanding of the situations Self-Lay Providers encounter. All of which is drawn on in the comments made in this response.

General Comments

Whilst appreciating the Ofwat direction of travel I am not certain that the proposals now out for consultation reflect sufficient market understanding to protect developer customers and allow fair and open connection competition in the years ahead. Hence, based on my experience, I provide some general comments before working through the set of Ofwat questions.

Firstly, it is surely naive to base a strategy on the assumption that company Developer Services fully control the cost base underpinning their connection charges. Instead it is their contractors (who do nearly all of the work) who largely determine the amounts being charged. This is because they are able to structure their contract offering in ways which looks to best reward themselves. Although companies may try to influence their contractors, and their suppliers, invariably the rates that become the predominant element of company charges are those determined by company contractors and/or suppliers. These getting applied with whatever (relatively small) uplift the company considers is reasonable.

Although Ofwat may claim to offer a number of 'protections' to developer customers against company charging abuses experience is that if a company says that what they charge is how their contractor has tendered then this gets accepted by Ofwat without any meaningful analysis of whether such rates are reasonable for the specific work content. This leads to a strongly held view amongst competitive SLP providers that Ofwat needs to better ensure that, especially, non-contestable work costs are not being unreasonably increased by company contractors to benefit their margins on work they are guaranteed to get. From a company provision perspective such unbalanced pricing may, in practice, be offset by lower rates on the contestable work (that the contractor may not be asked to do) but, if unchecked, company contractors are surely well able to structure their rates to protect their position and harm those looking to compete against them. To counter this it looks as though the tether concept should be extended to set allowable ratios between 'contestable' and 'non-contestable' works on typical water connection layouts. Thus ensuring that competition across connection markets is fair and not, increasingly (as they progressively experience loss of market share) distorted by company contractors themselves.

Another surprising factor, in Ofwat advancing the concept of 'tether ratios', is the apparent failure to recognise that water connections are an entirely separate activity to sewerage connections. This has resulted in 'tether ratio' proposals which compare Water Only Companies (who charge solely for water connections) with those of companies whose charges include both water and wastewater connections. The potentially distorting impact this has is illustrated later in this response and Ofwat is asked to restructure their analysis such that a direct comparison of solely water connection charges can easily be done.

Furthermore. the way that the costed scenarios integrates water and waste water connection costs, for companies who provide both types of connection, is felt to not clearly indicate the work differences to developer customers. Ofwat is therefore asked to get companies to separately produce scenario costs on a type of service basis. This would then facilitate developers working in water only company areas to readily identify the additional costs that they will incur when draining their sites (which the current arrangements do not).

Additionally, should the concept of tether ratios be advanced, is that the Infrastructure Charge element, plus the new charges covering environmental incentives, form sizeable proportions of the per property amounts on both individual connections and on site developments. Hence, as these type of charges are universally applied, regardless of the type of work, it would look to provide greater focus on the charges for the actual connection work if such (common charges) were omitted when determining the comparison ratios.

It also needs to be borne in mind that some companies provide site developments work on the basis of developers doing the excavation. This contrasts with 'one-off' connections when it usual for the company to do all the work (including street work excavation). So even though companies who normally charge for sites requiring mains on a no excavation basis may provide rates for company excavation these are usually tendered by contractors knowing that this type of work will rarely arise. Hence companies where no excavation work predominates may be able to adjust their full excavation rates to produce more favourable 'tether ratios' knowing that developer customers will only infrequently be charged for excavation. Protection against this happening is therefore needed.

As the last few years, with high and unanticipated inflation, has demonstrated companies have found themselves in the advantageous position have having long term contracts with index linking that may not match activity specific cost increases. Whilst such arrangements will eventually end, and status quo pricing return, in the short term competitive providers, who usually price at current market rates, have been disadvantaged. So mechanisms to prevent such market distortion arising again surely need to be considered by Ofwat.

Finally, developer customers needing either a small number of connections, or where work in the highway predominates, would welcome greater competitive choice of provider. This is because the road opening licencing costs companies incur is significantly lower than what a competitive provider has to pay to get authorisation to work in the highway (on work that is going to be adopted by the company). This issue, and the market constraint it causes, therefore merits being picked up in any Ofwat market review.

Responses to The Specific Consultation Questions

Q1. What are your views on our proposal to link charges for different types of development through the use of tether ratios? What are your thoughts on the use of ratios based on industry maximum figures, not average or median figures?

Whilst not impacting on this feedback reconciling some of the data produced by Ofwat (in their Tables 2 and 3) does not look to align with the figures extracted from company costed scenarios. In particular there looks to be differences in the data for United Utilities and Wessex Water.

It is noteworthy that Ofwat has included waste water connection costs in what they have provided for the Water and Sewerage Companies (but not for the Water Only Companies).

A full breakdown of sewerage connection cost analysis is appended with the range of company specific costings illustrated in the following table.

	Sewerage Connections Costs (£)			
	Scenario 1	Scenario 2	Scenario 4	Scenario 6
Average	2506	829	2286	1886
Minimum	1210	405	1441	1197
Maximum	5720	1131	4005	3410
Median	2191	801	2234	1799

Because of the entirely different basis of sewerage connections, and that much more of the work is able to be done by developers themselves, there appears to be a need to separately consider water and waste water connection costs. This can be done by extracting, as shown above, the waste water component from what Ofwat has calculated. Then to calculate 2 sets of tether ratios.

	Tether Ratios Without Sewerage			
	Scenario 1 to 4	Scenario 1 to 6	Scenario 2 to 4	Scenario 2 to 6
Average	1.4	1.6	0.5	0.6
Minimum	0.7	0.9	0.3	0.4
Maximum	2.4	2.9	0.8	1.1
Median	1.3	1.6	0.5	0.6

	Tether Ratios Water and Sewerage			
	Scenario 1 to 4	Scenario 1 to 6	Scenario 2 to 4	Scenario 2 to 6
Average	1.2	1.4	0.5	0.5
Minimum	0.6	0.8	0.3	0.4
Maximum	1.9	2.2	0.7	0.8
Median	1.3	1.5	0.5	0.6

Apart from for the maximums the ratios currently calculated (both together and separately) produce broadly similar outcomes. But separating out water and wastewater charges would then mean that the costs for anyone just wanting an individual sewerage connection would be controlled in ways which directly relates to the work they require. It also better future proofs the calculations.

Given that Ofwat is exploring setting ratios based on the maximum the differences caused by separating out sewer connections is material. An alternative, to give companies some scope when their costs are genuinely higher for, say, (individual connection) work in the highway could be to set the limit on an Upper Quartile basis. Thus allowing companies some flexibility but constraining excesses.

Other costed components which it looks sensible to remove from 'tether ratio' calculations are those common to all types of connections. These are the, otherwise regulated, Infrastructure and any Environmental Charges. As these are payable on all sizes of developments their inclusion looks to dilute the key charge differentials in the proposed ratios.

Also meriting consideration is that whilst some companies provide full provision scenario costings they normally operate on a developer doing the excavation basis. This can result in untested (in terms of not being exposed to customer scrutiny) rates from Scenarios 4 and 6 and the potential that, for the companies where no-excavation costings predominate, they can have costings which produce ratios that they find more favourable.

In addition to protecting customers just requiring one, or a few, connections competitive providers require similar measures to prevent companies allowing their contractors to charge in ways which unreasonably inflates the cost of non-contestable work against the contestable elements able to be done by SLPs and NAVs.

	Ratio of Non-Contestable Work in Costed Scenario 3 to Total Scheme Costs
Average	0.19
Minimum	0.12
Maximum	0.29
Median	0.18

The details of this calculation are appended but concerning is that the cross company range in total provision costs is £70996 (against a cross company average of £61884) with the non-contestable element range of £12805 (against an average for this work of £11065).

As contractors in more companies witness a greater proportion of work they have historically done being lost to competition it is envisaged that they may increasingly wish to distort the market by the way they price. Hence it is now imperative that steps are taken to control any tendency to wight non-contestable works costs to protect against the market distortion that could otherwise arise.

Whilst recognising why Ofwat wishes to protect small scale developers from excess connection charges there appears much that companies will be able to do to obtain favourable 'tether ratios'. It therefore looks as though more work needs doing on this before implementation.

Q2 What are your views on option 5 that companies should individually charge for separate activities involved in making service connections? Do you agree with our proposal to implement via changes to the wording of the CTWE?

Fully support the intent for Ofwat to get companies to comply with the cost breakdown template that they all supposedly signed up to deliver. There are however some practical difficulties as this approach assumes that all companies work with the same operational model. Whereas, in practice, there are many differences in the relations companies have with their contractors. These range from the traditional approach, whereby contractors just do the on-site work, to arrangements where contractors do all of the scheduling and planning in addition to the physical work. So, attempting to get realistic cost breakdowns for office based activities bundled into contractors rates is felt laudable but thwart with difficulties.

Q3. Do you have views on our proposals to add two new worked examples with the aim of providing additional protection for developments with limited choice? What are your views on suitable new scenarios?

In many ways the addition of further costed development scenarios is thought to just complicate matters for customers. This is because the envisaged, more extensive small, developments would just be a multiple of the current:-

- Scenario 1 covering single connection to a house from an existing main; and,
- Scenario 2 covering a single connection to a block of flats from an existing main.

The first covering a connection requiring 4m of pipework in road. The second covering a 63mm diameter (bulk/non-standard) connection having 4m of pipe in a road and 4m of pipe in unmade ground.

So just extending the coverage to:-

a) a housing development of 5 properties; and,
b) a housing development of 25 properties

Both without mains has the potential, if not well specified, to produce little more for customers than a multiple of the existing scenarios.

Hence Ofwat is urged to consider what type of work is not included in the current costings and to specify the scenarios accordingly. This may include:-

- short sided connections (in a pavement or unmade ground without any work in a road itself); and,
- long (cross road) connections where supplies to 2 properties share a common feed (or whose communication pipes are fed through a common duct); and,
- separate supplies taken off a multiport box (such as arises when properties on a small, private road courtyard are brought to the edge of the highway for connections at the same location); and,
- fire supplies provided alongside a domestic use connection.

Given such (not covered) connection types it should be recognised that a development of 25 units without a main is most likely to arise when a shared single feed (equivalent to a main) is provided. So much like the current Scenario 2. But 5 connections on the same application could well arise but in a range of different work type category ways. Hence, if additional situations are to be covered, Ofwat need to be very specific about what companies are to cost.

Q4. Do you agree with our proposed general guidance for RAG2 regarding a fair allocation of all relevant overheads across ALL expenditure areas, including developer services?

It is felt somewhat ironic that the scenario costing structure introduced by Ofwat was one that companies themselves constructed (and gifted to Ofwat). But even though it was supposedly signed-off by all companies it was known from earlier discussions with a number of companies that they had no intention of providing the full breakdown of overheads required by the actual template. Partly because the breakdown does not align with the company/contractor work split.

So, whilst having detailed overhead breakdowns would be helpful for market regulation, particularly to compare overheads being applied to contestable and non-contestable elements, it is far from certain how easy this would be to universally achieve. Nevertheless Ofwat are urged to press ahead with introducing RAG2 requirements to secure this information from companies. Also, being far from certain that there will be full immediate compliance, Ofwat will surely need to be ready to quickly follow-up any non-compliances, whether in non-provision of data or where it looks as though overheads are not being fairly applied.

Q5. Should RAG2 specify methods of overhead recovery for developer services? Are there any disadvantages to doing so? Are there any methods that you think would be appropriate to use across the industry that would drive consistency?

Whatever is introduced needs to reflect the market understanding discussed in this response.

With mainlaying work there is a need for a bespoke design and site specific planning covering the mains work. But the related service connections just require calling off and are usually done without any great planning. So whilst it is reasonable to expect companies to apply not insignificant overheads on mainlaying work any related on-site service laying costs are mostly covered by being done in conjunction with the mains planning.

Service connections in the highway, however, need to individually planned with street opening noticing a not inconsiderable related task. Hence proportionally larger overheads could be reasonably incurred on such 'one-off' connections.

An issue here is that it depends whether a company does the work scheduling and planning, and thereby incurs the overhead, or tasks their contractor with doing the various (overhead) activities. Where this happens the contract rates will invariably include both the actual work and the related overheads. So, whilst Ofwat should try and steer companies towards greater disclosure of overheads there are some practical difficulties in detailing what should be provided, especially when companies themselves are not actually incurring the overhead costs.

Q6. Do you agree that RAG2 could be extended to cover the recovery and allocation of overhead costs between developments with and without a mains requirement? Do you have any suggestions as to how this should be done?

As discussed above there are differences in the extent of overhead related activities between developments with, and without, mains. Hence it is felt reasonable for overheads for these different activities to be separately quantified.

From a competition perspective it is also important that the overheads applied on developments requiring mains are applied in ways which respect activity differences when alternative providers, either SLPs or NAVs, do the work. In many ways this is akin to where a company contractor does all the planning and scheduling themselves. So it is not necessarily easy to now set what overhead recovery should be and maybe this is something the proposed Ofwat market review could evaluate?

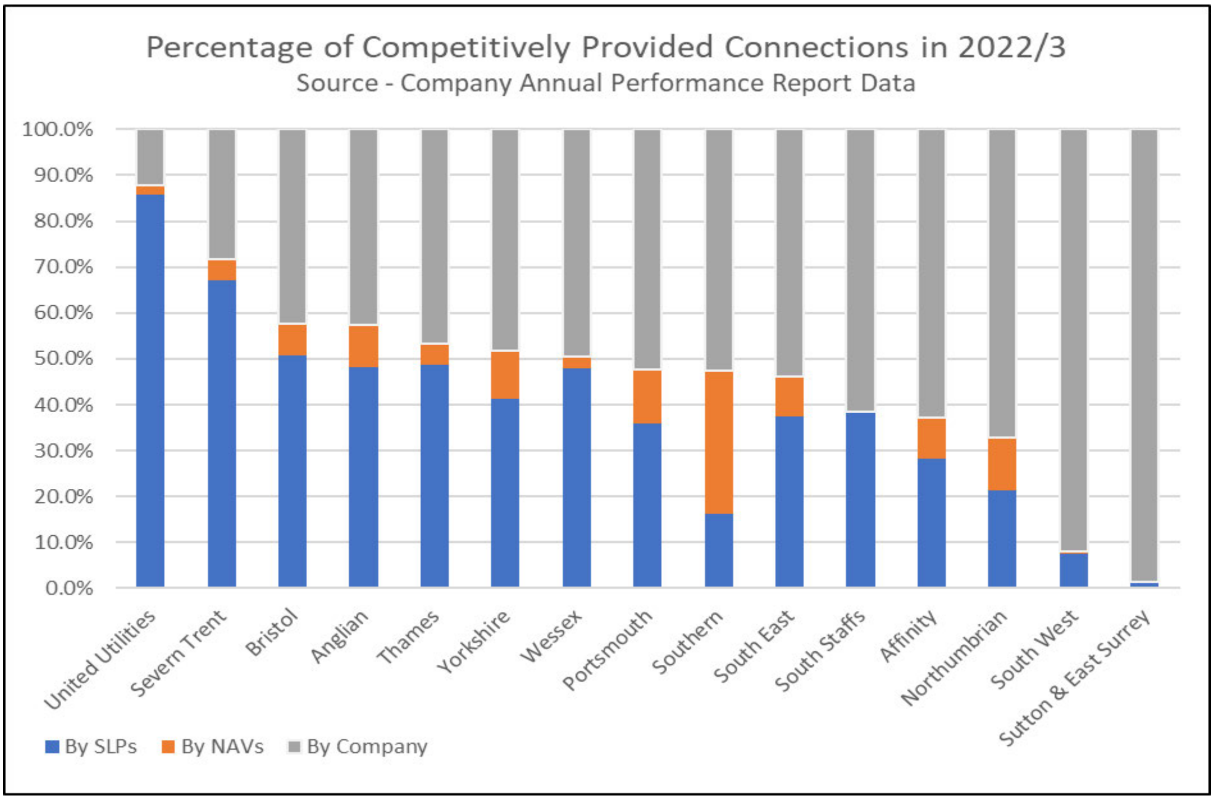
Q7. What are your views on our proposal to carry out a market review prior to PR29?

A market review looks overdue. Not least to establish why some companies have their connections extensively done by alternative providers whilst other companies, serving similar types of developments, continue to do high proportions of work themselves.

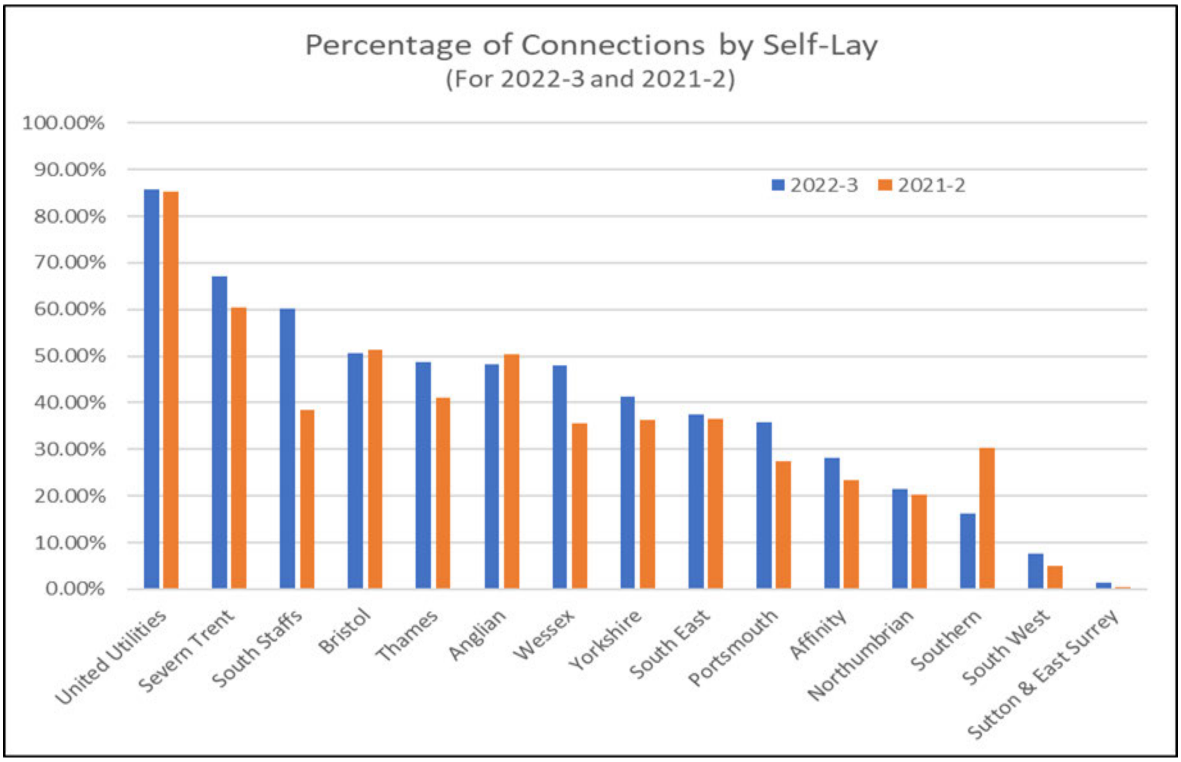
But before initiating such a review Ofwat should be clear on what it is looking to test and how significant costing differences are to be worked through. This is because previous experience of Ofwat reviews is that they identify cross company differences but then either their (or their consultants) market understanding is somewhat limited, or the commitment to tackle market ambiguities wains. This leaving developer customers stuck with knowing that whilst Ofwat has identified the issues they, as company customers, regularly encounter nothing substantive is done to tackle the resultant market distortions.

The timing of such a review needs to recognise the long lead time it can take for companies to change their contractors, and thereby re-align the way they operate against competitors. Hence the envisage review surely merits being done early in the AMP period so that learning can be enacted in time for any PR29 operating changes companies need to make.

My own analysis of market share, illustrated below, broadly mirrors (but also covering 2022/3) what Ofwat has shared. The first chart showing company activity share (based on number of connections) against both SLP and NAV provision.



The following chart looks specifically at self-lay volumes over the last 2 reporting years. Whilst there appears to be steady growth across a broad range of companies, as these strive towards those already at best practice provision levels, it is concerning that competitive provision clearly looks to be nowhere near established in a few companies. This is felt to be caused by the way these companies price and, should this situation continue, Ofwat are urged to make investigating pricing barriers a priority in their proposed market review.



In addition to working through why there continues to be marked cross company differences in competitive provision take-up aspects of connection provision which look to merit a thorough Ofwat review include:-

- Unpicking the various ways costings in the scenarios gets structured and to test how accurately they relate to the work needing to be done on actual development projects.
- A detailed review of those companies who have either Upper or Lower Quartile costing positioning and where a company's price base ranks their relative position differently in each of the costed scenarios (i.e. are relatively cheap for certain work types but much more costly for others and whether this allows certain work types to be cross subsidised).
- Studying whether company charges are weighted towards maximising returns on 'non-contestable' work elements (when compared to the amounts being charged for 'contestable' work) and how this impacts on the competitive connections market.
- Looking at differences between customer excavation and full company provision costings, especially where companies encourage customers to pick a particular delivery method.
- To evaluate how inflation is handled and whether companies with long term contracts are able to advantage themselves over competitors whose costs are always those when the work is done. Related to this whether companies predict an annual cost increase when setting their charges or are always 'catching up' by retrospectively trying to apply uplifts to cover their previous year losses. This being different to competitive providers who invariably have to pay the costs arising at the time each job is delivered.

- To consider where companies are with using the now standard Adoption Frameworks as a basis to build on to deliver customer service improvements and to be more responsive to their developer customers.

Any review should also look into the barriers which are preventing competitive providers offering to do individual connections in the highway (being brought about by the current road opening permit pricing which requires SLPs and NAVs to pay for one-off licences even though their work is going to be adopted by companies who are charged differently by highway authorities).

Q8. What are your views on our proposal that companies include historical variances between expenditure and revenues in setting infrastructure charges?

Support a pragmatic approach to the issue of balancing Infrastructure Charge income and expenditure but feel that the 5 year horizon does not sufficiently direct companies to do focused planning to ensure that charges and costs are broadly aligned. So whilst opening the balancing to include historical variances would propose that a 3 year time horizon is used with companies forced to not be able to reclaim historical (outside the 3 year) under recovery and be forced to use any over recovery as a credit against costs in the coming 2 years (of the 3 year period).

Q9. Do you agree with our proposal to enable companies to take account of upsized infrastructure when setting infrastructure charges?

Support upsized infrastructure being charged as network reinforcement and therefore funded through Infrastructure Charges. At issue however is whether the cost against income reconciliation should be either:-

a) when the reinforcement is built; or,
b) when beneficial use is made of the upsizing.

If both times are reasonably close it makes little difference but situations can be envisaged where capacity gets installed some 5 (or more) years before being substantially used. Where this arises it has potential to completely distort the income v expenditure balancing and means that future developers will benefit from costs paid by those who built properties much earlier.

Hence it is felt that whilst allowing upsizing costs a time limit needs to be set against when the new capacity, if chargeable, gets brought into use.

Q10. What are your views on our proposals relating to how we accommodate changes to the provision of income offset?

Thought that Ofwat had sufficiently signalled their intentions regarding Income Offsets for companies to plan sufficiently ahead to not find themselves in positions where they had offered discounts without any means for these to be funded.

Also, current Connection Charging Rule 20 surely applies in so far as a company cannot treat, as a separate class, customers who are rolling forward ongoing developments to those who apply post 2025.

Concluding Comments

In Figure 6 of their consultation Ofwat indicates a number of factors underpinning their approach to company connection charging. Drawing on the above comments concerns about this framework are:-

Developer customers are currently not well protected as:-

a) Work pricing is heavily dependent on tendered contractors rates (which companies themselves have limited scope to influence); and,
b) Long term contracts, during inflationary times, invariably mean that companies can advantageously offer low rates but then have (at retendering) to deal with potentially very significant rate increases. Thus making it difficult to maintain stable and predictable developer charges.

As is demonstrated by those companies where competitively provided connections remains low the current Ofwat framework does not universally facilitates competition in connection provision. To date Ofwat appears to have shown little interest in understanding why local barriers to entry appear to remain or whether markets are being protected by cross subsidies (from different types of connection work or other work done on the same contract). Hopefully Ofwat will better position themselves to have a meaningful market review which leads to the best practice market penetration levels being seen in some companies being universally demonstrated.

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Please make contact should you wish to talk through any of the above comments.

Appendices

Company	Sewerage Connection Amounts (£))			
	Scenario 1	Scenario 2	Scenario 4	Scenario 6
Anglian	507	428	406	401
Northumbrian	427	110	82	77
Severn Trent	558	352	334	331
Southern	831	590	568	844
South West	912	923	711	708
Thames	1040	726	393	383
United Utilities	505	302	284	281
Wessex	878	758	747	745
Yorkshire	1280	317	427	411
Average	771	501	439	465
Minimum	427	110	82	77
Maximum	1280	923	747	844
Median	831	428	406	401

Costs From Scenario 3 and 4 Supplying 50 Unit Development (with mains) (£)				
	Non-Contest Work (NC)	Contestable Work (C)	Mains and Connections (Total)	Ratio NC to Total
Anglian	13247	69449	82696	0.16
Northumbrian	11384	28329	39713	0.29
Northumbrian (Ex)	9458	36650	46108	0.21
Severn Trent	8841	37454	46295	0.19
Southern	13654	96870	110524	0.12
South West	8286	32870	41156	0.20
Thames	13240	71500	84740	0.16
United Utilities	7409	53517	60926	0.12
Wessex	11269	52314	63583	0.18
Yorkshire	9671	37401	47072	0.21
Affinity	15721	70410	86131	0.18
Bristol	7130	32398	39528	0.18
Portsmouth	9185	37173	46358	0.20
South East	10200	52951	63151	0.16
South Staffs	8410	43317	51727	0.16
SES	19935	60500	80435	0.25
Average	11065	50819	61884	0.19
Minimum	7130	28329	39528	0.12
Maximum	19935	96870	110524	0.29
Median	9936	47816	56327	0.18
Notes 1. costs exclude Infrastructure Charges, Income Offset and Environmental Allowances 2. totals from data extracted from company costed scenarios				