south east water

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

South East Water response

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Executive Summary

Thank you for the opportunity to respond to your consultation on the proposed changes to charging rules. Although the consultation provided a good high level overview of your proposals, we do not think it provides sufficient detail to understand how the end to end process will work and therefore what potential impact the changes might have. We assume that additional details will be provided in further consultations.

We do think that a simple, transparent charging methodology is vital. In the past developer services charging methodology has been criticised for being over complex and difficult for our customers to understand. Therefore we should have this in mind when we are making any changes to the charging rules. The principle of cost reflectivity will also be of fundamental importance to all our customer, and particularly to Self-lay providers who are trying to move into uncontested markets where margins are challenging.

We welcome the inclusion of the environmental component. We know that there has been significant work carried already in relation to water efficiency incentives, but to some extent this has raised more questions than answers, we are therefore pleased to see that Ofwat intends to continue with a working group to support this area.

Consultation questions

Q.1. 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 on the ratios based on industry maximum figures, not average or median figures?

We think that this methodology is potentially over complicated. If we are trying to ensure that customers carrying out uncontested connection work are being charged fairly then a simpler method would be for companies to recalculate all new connections in the uncontested market. 1. This would provide true cost reflectivity and 2. Would mean that any over recovery/under recovery would be dealt with directly with the customer carrying out the connection – customers could be provided with a detailed breakdown of all costs so that they can clearly understand the costs presented to them.

There is also a benefit to self-lay providers trying to move into the uncontested connection market. Margins in this area will be fairly low, therefore if any type of cost distortion occurs because of tethering this could potentially inhibit growth in this area of the market.

Tethering methodology – calculation of ratios

As we understand it, the proposal to tether charges for uncontested works to those for contested works can only be an approximate way of trying to avoid artificial increases of the former by maintaining some kind of proportionality between the two. The charges compared in the different working examples are all related to new connections services but not all of them are directly comparable. This means that what is achieved is only a very rough comparison.

How approximate this is intended to be is not clear. For example, the consultation document states on page 18: "*Divide the total costs for developer customers for each scenario by the number of properties to provide a unit cost per connection for each scenario*". Is the intention to derive a unit cost per connection? Dividing the total cost under worked examples gives a unit cost per property which is not a unit cost per connection, or in other words, is not representative of the cost of connections.

There are only limited explanations in the consultation document about the calculation of the tether ratios. In order to understand the proposal we used the ratios provided in Table 2 on page 19 to carry out a high level review. Based on this, and the brief explanations in the consultation document, it seems that the calculation of the ratios includes cost elements relating to types of works that are not directly comparable, and it is difficult to assess what the ratios would actually measure.

The ratios seek to ensure that the costs of works on smaller sites evolve in a somewhat comparable way to other costs and are capped by reference to the maximum industry ratios, but the calculation of the ratios should still represent the cost reflectivity of these charges. This could be achieved by only including the most relevant charges in the calculation of the ratios.

Ofwat has excluded the income offset but seems to have included the infrastructure charge in their calculation of unit rates. Infrastructure charges relate to reinforcement works which are not directly comparable to making either a single standard connection (worked example 1) or a single 63mm connection for 10 flats (worked example 2). The infrastructure charge is not in my view a useful

comparable cost and should be excluded from the calculation of the ratios.

Similarly, but to a lesser extent than the infrastructure charge, the cost of mains is not directly comparable considering that uncontested works tend to be those without mains.

Tethering seems to assume that the different new connection services costs will evolve in a similar way and that referring to the total cost of larger sites will maintain some sort of constant proportionality. This might be true for contractors' costs and companies' costs but is less likely to be true for third party costs including traffic management (e.g. lane rental) and land related costs. These costs could evolve at a different pace, they are more likely to apply to smaller sites than larger ones (there is no traffic management for on-site works and the developer has control of the land) and they represent a larger proportion of the total cost of a single standard connection and potentially a single large diameter connection. As these are pass through costs and have a significantly different weight under different worked examples, it would seem logical to exclude them from the calculation of the ratios. This would also avoid distortion over time (i.e. the distortion that would result from the fact that third party costs that form a significant proportion of the total cost on a single connection increase faster than other costs).

How would the ratios be applied?

The consultation provides only limited explanations on how the ratios would be applied.

Figure 7 on page 21 of the consultation document, shows two ratios potentially applying in respect of worked examples 1 (standard connection) and worked example 2 (63mm connection for 10 flats). The draft rule 18A on page 38 of the consultation document refers to ensuring that charges for all worked examples are set in a way that ensures the maximum Tether Ratios (plural) are not exceeded.

Companies should therefore ensure they do not exceed any of two maximum tether ratios and the ratios would operate to limit charges for both uncontested and contested works.

If this is correct, we believe it should be set out with greater clarity in further consultation about this topic and in the charging rules.

The impact of ratios being exceeded is not directly discussed in the consultation document. This would lead to either (i) the charges for uncontested works being reduced, which could mean they would no longer be cost reflective, and/or (ii) charges for contested works being increased, which could mean they are no longer cost reflective. Ofwat seems to think that market pressure on charges for contested works would limit excessive increases. This may be correct, but it would be useful for Ofwat to discuss this and for the charging rules to recognise that when the maximum tether ratios are exceeded and the cap applies, it will no longer be possible to meet the requirement to maintain the cost reflectivity of some of the charges.

The point made above about including only relevant charges and considering the weight of different cost components under different worked example is also relevant to the issue of cost reflectivity, as including all charges could result in distortion.

Implementation in the charging rules / CTWE

The draft charging rules refer to the ratios as calculated by Ofwat and published in the CTWE. The methodology for calculating the ratios should also be described in full in that document. Any changes to that methodology should be subject to consultation.

There could be some ambiguity in the drafting of Rule 18A following the introduction of two additional worked examples in respect of which no ratios will be calculated. This should be considered and if necessary, the wording should be clarified in the next version of the draft. This is because Rule 18A currently refers to "each scenario in the worked examples published by them in accordance with the document entitled "Common Terms and Worked Examples – English New Connection Rules" and therefore does not directly address the planned exclusion of the two new worked examples from the tethering of charges.

Q.2. 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?

Our current charging arrangements are specific on the component of each of our charges, we therefore do not foresee an issue with this.

Q.3. 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 scenarios?

We have no objection to the two additional worked examples, as the consultation document states that they will not be in the scope of the tether charges (i.e. no additional ratios will be calculated for those worked examples).

Q.4. 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?

We are not opposed to RAG2 containing general guidance regarding a fair allocation of relevant overheads but would need more information on the content and direction of the general guidance before giving full support.

Q.5. 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?

We do not oppose the idea of using a specific method which will remove ambiguity and ensure consistency between companies; however, we believe that some additional work is required to look at the options and these should be presented to companies for further consultation so that we can all understand the potential benefits and disadvantages of each method.

Q.6. 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 could be done?

We think that this may be possible, however, we would need to see what a more detailed methodology to understand what this would look like.

Q.7. What are your views on our proposal to carry out a market review prior to PR29?

Understanding developer services markets is vital to understand the true market conditions and where possible remove or alter regulation. We also think that this research should be completed as soon as possible to allow companies time to prepare for the changes to the environment and the challenges to come with PR29.

Discussing with companies what you are ultimately trying to achieve with this means they may be able to help you with shaping the data requests to get the maximum benefit from the data you receive.

Q.8. What are your views on our proposal that companies include historic variances between expenditure and revenues in setting infrastructure charges?

We agree with the principle that companies should take account of prior years' variances, which will help recovering the network reinforcement costs incurred and improve the cost reflectivity of infrastructure charges.

We support the changes to rule 52. However, we need to understand better the impact that this may have on customers to identify any mitigations we need to put in place, such as limiting the impact by spreading increases over several years.

Q.9. Do you agree with our proposal to enable companies to take account of upsized infrastructure when setting infrastructure charges?

We agree with ensuring that costs relating to additional capacity can be included in the calculation of the infrastructure charge, which will help recovering the network reinforcement costs incurred and improve the cost reflectivity of infrastructure charges.

Q.10. What are your views on our proposals relating to how we accommodate changes to the provision of the income offset?

We support the proposal to remove the balance of charges principle and income offset in respect in respect of agreements entered on or after 1 April 2025.

We support the removal of Rule 19 and related amendments to paragraph A1 of Appendix 1.

We support the amendments to Rules 5 and 55.

As mentioned in Ofwat's October 2021 consultation, the implementation of these changes would need to be discussed through further engagement between Ofwat, companies and developers, SLP and NAVs. This may consider for example, transitional provisions (i.e. how income offset will be applied in respect of agreements entered into before 1 April 2025) and the impact on the amount of charges including how any significant impact may be spread over several years.

Notes on changes to charging rules wording

The definition of the "Environmental Component" (Rule 5) does not expressly set out that it is part of the infrastructure charge. Rule 51 does not either.

Rule 53 provides that charging arrangements must explain the methodology for the calculation of the infrastructure charge and the environmental component. This wording seems to suggest that these are, or may be, separate charges.

Rule 52 as drafted (in particular the last bullet point) provides for adjustment for over or under recovery of the infrastructure charge but does not refer to the environmental component. This means that, based on the current drafting, the adjustment in that last bullet point may not apply in respect of the environmental component.

The consultation document states in section 4.1 relating to environmental incentives (on page 30), that Rule 52 will be amended to include reference to the ability to account for previous under or over-recovery of infrastructure charge revenue. We understand that it is therefore intended that Rule 52 as drafted would also deal with under or over recovery of the environmental component of the infrastructure charge. This is why the proposed drafting of the charging rules should be revised to produce what we understand to be the desired effect of Rule 52. This could be done by addressing the ambiguity we have highlighted above (i.e. that the current drafting does not include an express statement that the environmental component is part of the infrastructure charge).

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