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27 October 2023

Ofwat
Centre City Tower
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Birmingham
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By email: charging@ofwat.gov.uk

Dear Colleagues,

CHANGING OFWAT'S CHARGING RULES TO SUPPORT THE NEW DEVELOPER SERVICES FRAMEWORK

We welcome the opportunity to respond to this consultation. We support the overall approach that Ofwat set out in this consultation, including the key proposal of using maximum tether rates to protect sites that are not initially served by the contestable market.

We provide a range of views on the support questions in the appendix to this letter but consider these matters of nuance and detail rather than being fundamental challenges to the judgements Ofwat are making in expanding competition in this market.

Yours sincerely

[redacted]

Richard Price
Group Chief Engineering Director

Appendix

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?

We agree with your conclusion that option 1(capping charges) and option 2 (link to CPIH) would not support the development of the market or be an easy option to implement. We also support your conclusion on option 3 (capping net margins), but because of complexity, rather than the suggestion that companies would be encouraged to re-allocate costs from the contested to the uncontested market.

We therefore support option 4 – tethering charges ensures that smaller sites would benefit from the same charges as larger sites. However, in practice, all sites are potentially contestable. If charges are suitably disaggregated, then it will be difficult to know how tethering can work in practice.

We note you also include the further unbundling option in the consultation, and it is not clear what the link may be between the two measures. Having considered this, we do not think this will be a problem based on using a maximum tethered ratio but suggest the charging rules should allow companies to provide evidence that the tethered ratio should be flexed because their degree of bundling makes the tether unworkable.

This is our reason for also using the maximum tethered ratio – it provides less risk of a conflict between greater unbundling and the practical impact of tethering. “Comply or explain” may work better on tethering, and is also the principle set out that companies should not see ratios rise quickly towards the maximum, just because a maximum tether ratio has been set.

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?

We agree with this approach. It does not preclude companies not charging for specific activities (e.g. because they are providing smart meter roll out as part of a wider programme), where exceptionally there is an objective reason and this is available to all developers. Where elements are not charged (and not bundled), the change in the CTWE guidance does not affect this.

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?

We are happy to provide further worked examples and would be guided by developers as to what would be most useful. We welcome the clarification that these would not be subject to tethering initially, which would have been our only concerns on this proposal.

We support the introduction of the additional two scenarios but must reiterate feedback that we have previously provided to Ofwat about the options that customers have to secure these connections.

Within the South West in particular we do see customers take up the option to undertake excavation and reinstatement within the highway by securing a Section 50 streetworks licence and using an accredited contractor.

Whilst the take up of this option is moderate it is important to recognise that customers do have choice for these delivery scenarios.

With regards to the suggested scenarios, we do not normally see developments of over ten properties which do not require a new water main (other than blocks of flats which is already addressed within scenario 2). Consequently, the option for 25 properties seems a little high.

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?

We agree that the general principle and guidance should be added to RAG2. This is preferable to a specific overhead allocation requirement.

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?

We disagree with specific methods of overhead recovery being defined. The consultation does not set out any appropriate method to do this, and the example of a flat rate is likely to result in other challenges (such as in tethered ratios becoming outdated), just because a potentially inappropriate standard allocation methodology is being implemented. We do not believe there is a specific, appropriate methodology, and note that the SIA report did not recommend one, other than making a general observation which is not definitive as to the cause.

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?

We agree that mains and services are likely to have different drivers of overheads. In our experience they receive different direct overheads, but indirect overheads would be allocated proportionately to the direct cost. As long as this RAG2 extension made the distinction, we think the extension is straightforward to achieve. It is a general principle then that the overheads should relate to the direct activity (where they support it, such as contractor costs), and indirect overheads (e.g. office) are more likely to have a consistent driver between services and mains.

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

We agree it is expected practice for a market review to occur after implementing new market frameworks. The timing of this and its scope should be informed by market monitoring, against an *a priori* expectation for the market. As we stated in our response to the recent Licence Condition B consultation, we do not think that there is any purpose to assuming that the market review would result in the reversal of taking the developer services markets outside of the scope of price control – the default for any market study or review should be that the market will achieve its objectives and the review is considering how to extend this further or optimise its operation.

We do not think a ‘competition test; is likely to be appropriate. The developer services market has many different forms of competition (in particular NAVs), and the nature of the market is such that

there is limited scope for companies to encourage one or another form of competition. The value chain is such that some forms of development competition are cross-sector and are less driven by the water sector in any case. A market review is more appropriate therefore based on how its introduction benchmarks to prior expectations, qualitative assessment by market participants of barriers, and specific complaints and cases.

However, we remind Ofwat that competition is not exclusive to the activities undertaken by NAVs and SLPs as there are other areas where developers already have choices. For example, within the South West we offer developers the opportunity to undertake all onsite excavation and reinstatement for mains and services which allows the developer to manage both cost and programme of this activity.

Almost without exception developers take us up on the option and this is a good example where competition works extremely well albeit not specific to NAVs and SLPs but provides market opportunities for approved groundworkers and civil contractors to support developers.

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

We agree with this approach. It was ambiguous in the original charging rules as to how companies could balance costs and revenues (one requirement), without the ability to take variations into account (another requirement). The conclusion from the August 2021 consultation was not as clearcut as this consultation suggests – this was left open for further consideration. Where there are small variances, in practice this is below the level of certainty that future projections of costs and revenues (and property numbers by implication for revenues) can have.

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

We are not convinced by this change as it appears to fundamentally change the current infrastructure charge principle, which has the benefit of clarity and avoids retrospective assessment of past upsizing and costs incurred. We think five years is a sufficient time period for averaging. It was designed to avoid past costs being included, as otherwise we would merely have an averaging period which included historical costs (e.g. the average of 5 years historical and future, with an adjustment for the net variance over the past 5 years).

We also agree with your interpretation on the definition of network capacity, rather than Thames Water's narrower interpretation. Network reinforcement to support new development (and hence upsizing) can link to growth pressure on the network in general, rather than a development build out. Companies can phase infrastructure charges for long build out rates if they choose to, which avoids some of the issues that Thames are raising on the upsize / build out questions.

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

We agree with this approach. Although we disagreed with the removal of income offset, if this is the conclusion then the transitional arrangements (and not entering new agreements from 1 April 2024 that allow for income offset after 1 April 2025) is appropriate. Because this is governed by existing charging arrangement documents, this is the earliest that companies can reflect this expectation.

We recognise Ofwat’s requirement that companies should not enter new agreements that would require them to make any payments after April 2025 but highlight that, due to the construction periods, we will already have agreements in place that will not be completed until after that date.

We will consider this within our 2024/25 Charging Arrangements including the clarification of any transition arrangements.