



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

24<sup>th</sup> October 2023

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?

Thames Water has significant concerns about the introduction of a tethering ratio. We do not believe that tethering charges will protect customers and could unintentionally result in the creation of a cross-subsidy between smaller and larger developments and put companies at risk of breaching the requirement in Rule 18(e) of the Charging Rules for New Connection Services on cost reflectivity: new Rule 18A contained in Appendix 1 suggests charges between connections and requisition costs will need to be balanced to ensure the tether ratio is not breached, but balancing charges would mean that some charges will not be cost reflective.

In addition, as the values included in the worked examples include Infrastructure Charges and Environmental Incentives, we're concerned that tethering could have further unintended consequences, as detailed below.

Thames Water does not believe the tethering ratio proposals address the underlying causes of lack of competition for the activities which Ofwat is attempting to protect. The tether ratio may result in incumbent water companies charging less than the cost to deliver on small connections activities, which could further hinder competition in this area.

For Thames Water, the specific issues are as follows:

- Infrastructure Charges have been included in the values lifted from the worked examples. The Infrastructure Charge makes up a different proportion of the overall costs in the four worked examples ranging between 6% to 21%. Ofwat require the Infrastructure Charge to be based on Network Reinforcement spend and therefore any change to the requirement for Network Reinforcement because of developer activity would impact the tethering ratios disproportionately.
- Environmental Incentives have also been included in the values lifted from the worked examples. Similar to Infrastructure Charges, the proportions of the overall costs in the worked examples range from 4.5% to 16%. Under the proposals effective from 1<sup>st</sup> April 2025, an Environmental Component will be introduced, and the balance of charges principle will be removed. The Environmental Incentive is required to offset the Environmental Component across the AMP, but not necessarily within each year. This will change the overall cost in the worked examples and will then fluctuate from year to year in order to comply with these new rules, and each scenario will move by a different proportion impacting the tethering ratios.
- Infrastructure Charges, Environmental Components and Incentives are subject to specific methodologies about how they should be calculated and they fall within the price control, whereas the other activities in the worked examples are moving outside the price control, creating a potential conflict on how to balance the charges and recover any shortfall should tethering be introduced, and a potential conflict on how to ensure compliance with all methodologies and rules relating to the setting of all charges and incentives.
- As contestable developer services activities are moving outside the price control, all expenditure must be funded by revenue from developers. The charging rules also require that connections charges are cost reflective. Tethering introduces restrictions on charges which could result in a shortfall in recovery of charges subject to the tether. Companies would need to balance back the shortfall from other new connections charges, otherwise the consequence would be that shareholders pick up the shortfall,

which is not appropriate. However recovering the shortfall through other charges creates a cross-subsidy between larger and smaller developers and would cause companies to breach the rules on publishing and recovering cost-reflective charges in relation to those developments which are subsidising the tether; Ofwat have not explained how companies should balance costs to recover any shortfall to ensure tether ratios are not exceeded, but new Rule 18A suggests that water companies will have to allocate costs to activities which sit outside the tethering, leading to market distortions which Ofwat wish to avoid.

- Our schedule of rates contract has fixed overheads set separately for Service Connection and Mains activities. Work volumes could influence the split when the contracts are renewed or extended, however, the relationship between the costs is not necessarily linear particularly in a constrained supply environment. Smaller jobs/volumes allow you to tap into a more flexible “at the moment” resource pool in a way that larger jobs do not.
- The tether could also prejudice future contract negotiations. Having a tethering mechanism could affect the number of bidders when we renew these contracts depending on the bidders view of whether they can deliver the works within the mechanism. The mechanism could also affect our ability to negotiate certain rates as bidders would be aware of the industry benchmark for certain activities. Market engagement and enhanced procurement commercial assessment criteria could be used to mitigate both of these risks. Essentially this would set an upper end price – given the suppliers are not just bidding in this industry but in others, there may be price points where they decide to transfer activity into adjacent activities. Medium to Large developments typically present an economies of scale opportunity that single service and block of 10 flats would not.
- Materials costs may move disproportionately between the scenarios; for example, if prices for materials increased, this would have a greater impact on the cost of connecting larger developments requiring mains and connections, as more materials are required for larger developments. This would increase the overall cost of connecting larger developments but may have less of an impact on the cost of smaller developments requiring connections only. Increasing materials costs could have an impact on the tether ratios to the extent that it doesn’t provide the intended protection. In this scenario the requirement to be cost reflective would provide the protection, not the tether.
- The scenarios involving mains provision also include more traffic management – road closures, parking bays and permits, all of which are outside water companies’ control. For Thames Water, traffic management is a significant proportion of the overall costs recovered through our fixed tariffs at c.20%. Similar to materials, traffic management increases the overall cost of the larger development scenarios compared to smaller developments, meaning the tether ratio doesn’t provide the intended protection. The requirement to be cost reflective and the proposals regarding unbundling should provide the required protections.
- The proposal to add further guidance to overhead allocation will impact the existing tariffs in different proportions across all the water companies, meaning that the tether ratios are likely to be further impacted from the current position. Further details follow in the responses to Q4, Q5 and Q6 below.

Thames Water believes the requirement in the charging rules for charges to be cost reflective of service, the unbundling proposals, and the clarification in allocation of overheads will deliver the required protection to customers without the need for tethering. We do not believe that the tether principle achieves the aim of protecting customers or making sure the costs they pay are ‘appropriate’. The costs should already be appropriate due to the rule on cost reflectivity. The

tether will enable smaller developers to pay less than the cost for providing the service in an attempt to protect them, but this will be at the expense of other customers or shareholders.

If Ofwat proceed with implementing tethering, then Infrastructure Charges and Environmental Components and Incentives should be excluded from the ratio calculation.

[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?](#)

Thames Water agrees that there would be some benefits to disaggregating some of the activities from the bundled fixed prices both from a transparency and competition perspective, but we have some concerns about the level at which this is implemented.

Thames Water would like to request further clarification from Ofwat as to the level of unbundling they are proposing as it is not explicit in the consultation. Are Ofwat proposing all individual activities are split out and charged for separately down to “service pipe installation; Boundary box fitting; Meter installation; Excavation; Reinstatement”, or just those to comply with the detail requested in the rows on the CTWE i.e. traffic management and cost of meters? Companies would need clear guidance on the level of unbundling to avoid companies interpreting the requirements differently, which would not allow for direct cost comparisons.

If Ofwat is proposing unbundling of all individual activities then, Thames Water would not be able to comply with this level of unbundling due to our commercial arrangements, as these components are not separated out under the schedule of rates contract which we have in place with our contractors (which runs into AMP8). Unbundling to this level could also hinder customers from being able to use the Charging Arrangements to estimate their costs, as this would become very complex.

However, if Ofwat are proposing unbundling down to the level set out in the rows of the CTWE (which would involve unbundling of traffic management and meter costs from connection and pipelaying charges) then it would be possible for Thames Water to unbundle the cost of meters and most traffic management, although this would not be as simple to implement as Ofwat has suggested.

Some basic traffic management is embedded in the schedule of rates prices we have with our service delivery partners such as 2-way traffic lights, so we would not be able to separate these charges from the construction costs.

In relation to traffic management costs, in the Thames Water region there are 57 separate Highway Authorities each with their own pricing schedules, and their publication of rate changes may not align with our annual tariff review. At the moment our fixed prices include a blended average of actual traffic management incurred for each type of job. It is unclear whether Ofwat's intention is that we:

- Include all 57 highway authority's prices in our charging arrangements based on the price they have in place when we finalise our annual charges. This would make it very difficult for customers to work out their charges from our Charging Arrangements alone:

and would add a greater level of complexity to our quotation process and ultimately increase our design price, or

- Thames Water could investigate whether it would be possible to publish a set of bandings for traffic management to simplify this for customers, whilst also being more cost reflective for each job. This would mean grouping the highway authority's prices into suitable bandings such as high, mid, low, or none and setting the price at the average. While being more complex than the current arrangements, this would be simpler than the full disaggregation mentioned above and make it feasible for customers to calculate their own costs.

Companies are also required to publish worked examples, and increasing the complexity of traffic management charges will be more difficult to translate into worked examples. Ofwat would need to provide guidance as to which highway authority prices or bands are to be used if worked examples are to be of benefit to customers and to Ofwat when comparing water company charges e.g. a 7-day road closure in Kent might cost £710 whereas it would cost £5,996 (plus advertising costs) in Newham.

In addition, in order to unbundle our traffic management charges, Thames Water would need to make changes to our systems which will take time and will incur cost to implement, so we will need to commence work on this prior to the final statutory consultation outcomes being confirmed, and the information notice and final charging rules being issued for the 2025-26 charging year. Thames Water would therefore like to discuss this proposal further with Ofwat ahead of commencing system specification design.

In relation to meter costs, Thames Water already has the ability to charge separately for the cost of a meter including meter proving activities and the cost of making it "smart", as these are provided separately to Self-lay providers or for internal developments such as flats, and we do not see any issues in unbundling this element. However, where Thames Water provides the connection, the cost of installation of the meter is embedded in the schedule of rates price for a new connection, so we cannot separate out the installation cost due to the commercial arrangements we have in place for AMP8.

**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?**

Thames Water does not have any issues with adding new worked examples which cover suitable scenarios. The proposed additional example of 5 houses could be useful but will require clarification if this would be five single connections or a 5-port manifold.

The 25 properties proposal would be an unlikely scenario with individual service connections off an existing main. This number of properties is more likely to require the services to come off a new main, very similar to examples shown for medium sized housing developments.

Alternatively, a suitable example for a house or office converted to flats with a prescribed number of manifolds may be useful as none of the current examples include a manifold or redevelopment scenario.

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?

Thames Water agrees with the proposal to add further guidance to RAG2 on overhead allocation. This would remove any ambiguity with regards to prior guidance on overhead allocation, such as the 2014 independent review which advised that company on costs should not be recovered through S45 connections, which would have led to some of the differences between water companies which were highlighted by SIA Partners. However, Thames Water believes that the guidance should be widened to cover all central and department overheads and not just capital programme expenditure as there will be different accounting treatments across the water companies.

Additional guidance from Ofwat would also be required regarding the definition of overheads and the type which should be allocated to Developer Services activities, which would further minimise the apparent inconsistency across the industry.

Should Ofwat decide to add further guidance on overhead allocation, then this could have a different scale of impact to tariffs across the various water companies depending on their current methods, impacting the tether ratios. These would then need further consideration before they could be reasonably implemented.

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?

Thames Water do not agree that Ofwat should specify methods of overhead recovery for developer services. As suggested in our response to Q4, we believe Ofwat should provide specifications defining the type and manner of overheads which should be allocated to Developer Services activities to remove the apparent inconsistency across the industry. In particular we note that, in order to avoid undue discrimination between individual business areas as proposed within Q4, any prescribed method for overhead allocation for developer services activities may need to be consistently applied to all other business areas. This could thus result in a wider accounting policy change to which we believe a broader consultation is required. Alternatively, if this were not the intent, then we believe this would result in a further reconciliatory item between the regulatory and our statutory financial statements.

Any prescribed basis of overhead apportionment, if this differed to our current methodology, could result in significant cost to implement, in particular to our financial systems and processes.

The prescription of a specific overhead recovery may also conflict with individual water company commercial arrangements which may be a percentage or set amount.

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?

Thames Water does not agree that a service connection job should have a different overhead allocation depending on whether a new main was also requisitioned or not. Service Connections are often laid in a different timescale to the Main, generally in phases as housing developments are progressed and so are carried out as a separate activity. Thames Water believes that appropriate overhead allocations should be made to Service Connection activity and separately to Mains activity based on directly attributable expenditure as required under accounting standards. In our commercial arrangements, the amount of contractor overhead is contractually set separately for Service Connections and for Mains.

As suggested in our response to Q4 and Q5, Ofwat should provide guidance as to the type and manner of overhead that should be allocated rather than the methodology.

If a different rate is applied to developments with and without mains, the tether ratios could be impacted as work mix and overhead costs change over time meaning it may become impossible to meet the guidance of both requirements.

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

Thames Water agrees that a market review would be beneficial and would like to request early visibility of what the expected data request would be, particularly where it is not part of our regular APR reporting tables.

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

Thames Water fully supports this proposal. As Infrastructure Charges still fall within the price control, this proposal reduces the risk of cross subsidy between customer types (subject to our query raised in response to Q9 below). It also ensures the price that developers pay is cost reflective of the network reinforcement expenditure made.

Revised Rule 52 in Appendix 1 is not explicit about which years can be included within the historical reconciliation. We believe that reconciliation should commence from 2025-26, as prior years' under or over-recoveries will have been included in the Price Control revenue correction mechanism for AMP7, so undertakers should not be able to account for the over or under-recoveries again through an Infrastructure Charges reconciliation. Such a reconciliation will not have been considered in PR24 submissions for AMP8 price controls. We have suggested some proposed amendments to Rule 52 below.

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

In the PR24 Final methodology Appendix 3 section 4.4.2, Ofwat stated that *"Incumbent companies can set infrastructure charges to recover the costs of network reinforcement from all foreseeable developer applications"*. The proposed wording amendment for rule 52 states *"additional capacity in any earlier Water Main or Sewer that will fall to be used in consequence of the provision or connection of a new Water Main or Sewer within the relevant 5-year period"*.

Thames Water agrees that all foreseeable development activity, including additional capacity in earlier mains or sewers should be included in the definition of network reinforcement to ensure this investment is funded through Developers, but we are concerned about the reference to the

'relevant 5-year period' in the proposal for revised Rule 52. We believe that restricting the allocation of this investment to the relevant 5-year period could create a cross-subsidy between customer types and would be grateful if Ofwat could clarify if this change to rule 52 is what was intended. We believe this would constitute a change of position since the publication of the PR24 Final methodology and is not consistent with our submission which assumes all investment would be recovered from developers in the AMP in which it was incurred.

Restricting the inclusion of earlier spend to that which will be used in the relevant 5-year period would create a scenario where the incumbent water company is investing ahead of need but cannot recover the costs from developers for a period of time which could cross multiple AMP periods. We have examples of c.15+ year planning horizons. As Infrastructure Charges are inside the price control, Thames Water believes that if the rule continues to refer to the 5-year period, this investment ahead of need would therefore initially be funded through other bill payers, and re-couped in future AMP periods. This would also create a significant administrative burden on the incumbent water company to track the expected build profile for every development where it is expected to exceed the initial 5-year period when the investment is made. This would also involve calculating an allocation of the earlier investment cost to the build profile and reconcile this on a rolling basis for the calculation of Infrastructure Charges.

Should Ofwat proceed with the drafted wording for rule 52, then we would also request Ofwat consider how this will be reported in the regulatory tables 4N, 4O, 2J and 2K as the current RAG definitions refer to expenditure in the period, whereas rule 52 would require expenditure to be allocated to future periods when setting Infrastructure Charges.

## Appendix 1. Draft Changes to our Charging Rules

We have reviewed the proposed drafting amendments contained in Appendix 1 and have the following initial drafting proposals:

### Rule 5 – definitions:

"Environmental Incentive" means a payment or payments to **promote water efficiency and sustainable drainage made to a developer by an undertaker in accordance with the principles contained in "Guidance for Environmental Incentives – English New Connections Charging Rules"**.

"Tether ratio" means the ratio **set by Ofwat and published in the "Common Terms and Worked Examples – English New Connection Rules" published by Ofwat.**

### Rule 51:

"Each undertaker whose area is wholly or mainly in England must offer an Environmental Incentive in their Charging **Arrangements.**

### Rule 52:

Infrastructure Charges must be determined in accordance with the principle that the amount of such charges will over each period of five consecutive Charging Years beginning on 1 April 2025 and, thereafter, on 1 April in each subsequent year cover the costs of Network Reinforcement that the relevant undertaker reasonably incurs, (or has already reasonably incurred, in the case of additional capacity in any earlier Water Main or Sewer that will fall to be



used in consequence of the provision or connection of a new Water Main or Sewer within the relevant 5-year period), before the application of any Income Offset and in calculating the costs of Network Reinforcement the undertaker must:

- take into consideration both the number and relevant costs arising in consequence of new connections in the undertaker's own area, and in the areas served by New Appointees with whom the undertaker has an agreement for bulk supplies of water or bulk discharge; and
- adjust for any under-recovery or over-recovery of infrastructure charge revenue in previous Charging Years which has not already been adjusted for in the calculation of any previous infrastructure charge or the AMP7 Price Control Revenue Correction mechanism.





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