

# Changing charging rules to support the new developer services framework

## Consultation by Ofwat August 2023

### United Utilities Water response – October 2023

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#### Introduction

UUW welcomes the opportunity to comment on Ofwat's consultation on changing the charging rules to support the new developer services framework.

We are supportive of changes to the charging rules that improve transparency and support markets.

UUW broadly supports the proposed changes to the charging rules to support the new developer services framework to complement the developer services market.

We are supportive of Ofwat's proposal to link charges for different types of development through the use of tether ratios. Whilst we do not consider it absolutely necessary (given that the risk is low and there are already cost reflectivity requirements in the charges scheme rules, which provides some protection to smaller developments), Ofwat's proposal seems to be pragmatic and proportionate.

Should tethering ratios be introduced we consider the use of ratios based on an 'upper value' (e.g. the current industry maximum) to be more appropriate than average or median figures, as the tether ratio should be a limit that companies should not exceed, not a target.

We agree in principle with the proposal that companies, where practicable, should individually charge for separate activities involved in making service connections to promote greater transparency of charges.

We agree that the most appropriate place to implement the changes is to incorporate them into the Common Terms and Worked Examples (CTWE) document that accompanies the new connection charging rules.

We consider further refined worked examples could be a useful benchmark for comparing the cost of carrying out certain connection scenarios where no new mains are required. We are supportive of additional published scenarios that are representative of typical developments across the industry.

We agree with the proposal to add a general principle to RAG2 that would ensure that central and departmental overheads should be added to all capital programme activities (base, enhancement and developer services) in a fair manner with no discrimination according to the investment area.

We do not consider that there is a need to specify methods of overhead recovery for developer services in RAG2. Overhead recovery may vary depending on how services are provided. Companies should be able to decide their own approach and demonstrate that their recovery of overheads is cost reflective.

We do not agree that there is a need to extend RAG2 specifically to cover the recovery and allocation of overhead costs between developments with and without a mains requirement. We consider that the addition of general guidance in RAG2, regarding a fair allocation of all relevant overheads across all expenditure areas including developer services, to be sufficient.

We are supportive of Ofwat's proposal to carry out a market review prior to PR29.

We agree with the principle that companies include historical variances between expenditure and revenues in setting infrastructure charges where it is appropriate to do so.

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We agree with the proposal to enable companies to take account of upsized infrastructure when setting infrastructure charges.

We agree with the proposal to accommodate changes to the provision of income offset through the removal of the balance of charges rule.

We agree with the proposal to amend rules 5, 52, 55 and 57 to refer to income offset only in connection with existing agreements, recognising the expectation that the ability to offer income offset from 1 April 2025 for new agreements will be removed.

The draft wording changes to the English New Connection Charging Rules (ENCR) in Appendix 1 of the consultation appear to cover all the areas of change referred to in the consultation document. We note that in the consultation Ofwat advises it will consult again if it decides to proceed with any of the proposed wording changes to the charging rules. We do not propose to make any specific comment regarding the individual wording changes in this consultation response.

We have responded to each of the questions set out in the consultation below.

## **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 of ratios based on industry maximum figures, not average or median figures?**

We acknowledge Ofwat's concern that customers with limited market choice may be at risk from overcharging once site-specific developer services are removed from the price control.

We do not consider that the proposal to link charges for different types of development through the use of tether ratios absolutely necessary (given that the risk is low and there are already cost reflectivity requirements in the charges scheme rules which provides some protection to smaller developments).

However we would support the proposal to link charges for different types of development through the use of tether ratios if Ofwat considers it necessary. Ofwat's proposal seems to be pragmatic and proportionate. The introduction of tether ratios is a relatively simple way to enhance the level of protection. We consider this to be quite straightforward to assess and to operate, as it would just form part of the annual charges setting process.

Should tethering ratios be introduced we consider the use of ratios based on an 'upper value' (e.g. the current industry maximum) to be more appropriate than average or median figures as the tether ratio should be a limit that companies should not exceed, not a target. Also, the tether ratio needs to be static (albeit reviewed periodically) and not dynamic (i.e. not just based on prior year values) otherwise this will not promote stability in charges. This would be a particular issue if the tether was the prior year average, as this would continuously push charges downwards due to the tether mechanism alone, and not due to cost reflectivity.

Companies should not be required to arbitrarily rebalance existing charges in a way that might conflict with existing cost reflectivity. The purpose of the "multiplier cap" would be to prevent charges from substantially drifting in that direction.

The use of average or median figures, whilst initially offering smaller developer protection in the short term could result in charges for smaller developments becoming less cost reflective over time. This would also make it more difficult to compare new connections charges across the industry.

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## **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?**

We agree in principle with the proposal that companies, where practicable, should individually charge for separate activities involved in making service connections to promote greater transparency of charges.

We are supportive of charges that reflect the costs of the relevant service and steps taken to improve the granularity and transparency in this area. However it is important this is balanced with other charging principles, recognising that all the charging principles are important and that sometimes these are in tension.

Some of the feedback received from Ofwat following the review of incumbent support for effective markets (project RISE) has informed the steps we have taken through AMP7 to focus on both cost reflectivity in our charges and recovery of those costs. In 2022 U UW extended our current developer services contract and took the opportunity to incorporate changes to improve cost granularity. At this time the majority of these charges were transitioned into our 2023/24 charges scheme. By AMP8 they will all have been transitioned to aid with better cost recovery. Significant investment has been made into new systems to provide better data on our quoting processes to ensure we recover costs by the end of AMP7. These changes will ensure that U UW is well positioned for the proposed changes to the developer service price control model.

We agree that the most appropriate place to implement the changes is to incorporate them into the Common Terms and Worked Examples (CTWE) document that accompanies the new connection charging rules. As the CTWE provides a standard template this makes it easy for companies to populate and provides consistency across companies aiding comparability.

## **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 new scenarios?**

We acknowledge Ofwat's concern that customers with limited market choice may be at risk from overcharging once site-specific developer services are removed from the price control.

We are supportive of changes to the charging rules that improve transparency and support markets.

We consider further refined worked examples could be a useful benchmark for comparing the cost of carrying out certain connection scenarios where no new mains are required and support the introduction of additional published scenarios that are representative of typical developments across the industry.

Based on activity in the U UW region we consider a suitable scenario would be a housing development of either 3 or 4 properties rather than 5 properties as proposed by Ofwat. This is based on site data in our 2022/23 developer services information request which showed that in 2022/23 we only had 13 sites with 5 properties where no new mains required. This is compared to 56 sites with 3 properties and 34 sites with 4 properties.

In relation to the proposed scenario for 25 properties this is not a very common occurrence in our region with only 4 sites in 2022/23. In 2022/23 around 88% of sites with the number of properties connected ranging between 10 and 25 properties had the characteristics of apartments (one connection to multiple properties) rather than being individual houses. On this basis we consider the usefulness of introducing an additional scenario for between 10 and 25 properties to be limited.

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## 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 agree with the proposal to add a general principle to RAG2 that would ensure that central and departmental overheads should be added to all capital programme activities (base, enhancement and developer services) in a fair manner with no discrimination according to the investment area.

We note in the consultation that the SIA partner study published in August 2021<sup>1</sup> showed that companies take very different approaches to cost allocation. We recognise that variation in charges may be due to inconsistent definition of overheads, different interpretations of reasonable costs to recover and application of central overheads.

We consider that a general principle added to RAG 2 would be an appropriate first step to aid consistency and help mitigate differences in approach as highlighted by SIA.

## 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 consider that there is a need to specify methods of overhead recovery for developer services in RAG2 as that may vary depending on how services are provided.

We recognise that prescribing one or more approaches that companies must use to recover overheads would aid consistency, but it is also important that methods of overhead recovery support cost reflectivity.

Variability in overheads may naturally occur across companies due to the contractual arrangements in place and companies broader approaches to overhead recovery. It is important that proposed approaches are sufficiently flexible to allow individual companies to assess the most appropriate method for overhead recovery.

We consider that companies should be able to decide their own approach and demonstrate that their recovery of overheads is cost reflective.

To aid consistency, transparency and allow comparison across companies we suggest an additional disclosure could be included in the Regulatory Accounting Guidelines, rather than defining a specific method.

For example in RAG3, companies are required to publish an accounting methodology statement to describe the method for disaggregating costs. An example of this is section A2.5 which sets out “companies should describe the method or cost driver that the company has used to calculate allocations between the price control units”. A requirement could be added to describe the method for allocating costs to developer services, and could include quantifying the percentage split of direct and indirect allocations.

It is also important to ensure that costs recovered through developer services are equivalent for both the appointed entity and competing organisations. Without this equivalence the associated competition and therefore the market would be less efficient, reducing the benefits for customers. Conversely, ensuring an equally efficient operator could compete is obviously necessary, and to support this the incumbent cannot be cross subsidised from the control. These excluded costs should include all equivalent costs covering use of shared services such as finance or HR, administrative costs, construction activities, margin and any other costs related to delivering the services set out within the proposed draft wording.

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<sup>1</sup> [Connection Charges for Developer Services in England – Root Cause Analysis](#)

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In our recent response to Ofwat's consultation under sections 12A and 13 of the Water Industry Act 1991 on proposed modifications to Condition B: Charges (13 October 2023) we stated we would support the creation of a RAG4 supplementary appendix to provide additional clarity to be confident of a consistent approach being taken by all companies on which developer services activities are included or excluded from the price control. This should include consideration of the following:

- **Engagement with the planning process.** We would suggest that engagement with the planning process be included within the price controls, and not be excluded. This activity includes work on strategic plans to help understand and guide long term resource requirement, including statutory engagement into the planning process.
- **Engagement with developers, SLP and NAVs.** There are a number of activities undertaken to support the operation of both developer services and non-developer services related incumbent activity, such as water resource planning. We believe that this engagement does not clearly sit either within or fully excluded from the controls. We would propose that companies should be expected to allocate these costs across both elements based on a reasonable rationale.
- **Provision of NAV services.** Activities relating to the provision of services to NAVs do not necessarily align with other developer services activities. For example when meters are installed on the connection to a development being supplied by a NAV the cost of that meter are not charged to the NAV. The cost of supplying and installing the meter to a NAV site should be within the control, or recharged from developer services to the control. This does not align to meters being installed in other circumstances.
- **Provision of common carriage.** The notes in the consultation on Condition B: Charges suggest that developer services activity relating to common carriage provision S66B-C and s117A-D (s66d and s117e agreements) should be considered excluded from a price control. Having clarification of this position set out within RAG4 would be beneficial to ensure consistency. Additional clarity as to which activities are excluded, and which not, from across the process set out within the access code is required. This includes the application and feasibility studies, but given the low levels of activity, and therefore associated experience, further work may be required to define the activities appropriate categorisation.
- **Administration charges.** It would be appropriate to clearly set out the expectation that the site specific developer services activity extends beyond the physical activity to include any costs associated with the provision of that service. This includes administration costs and charges related to that physical developer services activity.
- **Incumbent reporting obligations.** When carrying out developer services activities there are obligations that place a heavier burden on the incumbent than other trading parties. These obligations include those relating to regulatory reporting (RFIs, APR, Price Review, D-MeX). Whilst these costs may not be able to be fully included within the controls, we would expect that where practicable they should be.
- **Management of the Lloyd's accreditation scheme.** Clarification should be provided with regard to the management of the Lloyd's accreditation scheme (WIRs) which should be identified as included costs, rather than excluded. Obviously the costs of the incumbent meeting the same obligations, such as training, must be excluded. The operation of the overall scheme should be a responsibility sitting within the control. It would seem perverse if the costs of operating the scheme were recovered through site specific developer services costs.
- **Allocating shared services costs.** Where services are shared such as finance, HR, regulation costs or debt collection, companies should as usual attribute costs across activities based upon an appropriate rationale. Allocation guidance can be created to support the application of this

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attribution, as is the case with retail costs in RAG2. There would be value in considering the value chain of developer services activity in detail and providing clarity as to the point at which the exclusion applies for each form of activity. Trading parties would be well placed to support in this development, once the overall positions are clear.

## **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 should be done?**

We do not agree that there is a need to extend RAG2 specifically to cover the recovery and allocation of overhead costs between developments with and without a mains requirement.

We consider that the addition of general guidance in RAG2, regarding a fair allocation of all relevant overheads across all expenditure areas including developer services, to be sufficient.

We consider that companies should be able to decide their own approach and demonstrate that their recovery of overheads between developments with and without a mains requirement is cost reflective.

We acknowledge Ofwat's concern that customers with limited market choice may be at risk from overcharging once site-specific developer services are removed from the price control. This could be mitigated with an additional disclosure requirement in the Regulatory Accounting Guidelines, rather than introducing specific guidance for developments with and without a mains requirement.

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

UUW is fully committed to supporting effective markets in developer services.

UUW recognises that the principles of competition and markets play a role in raising performance standards and driving efficiency, and that there are opportunities for markets to operate within the water and wastewater sector in order to deliver benefit to customers. UUW's activity in relation to market development has been supportive of securing the best interests of customers. We believe that customer experience should always be at the heart of decision making.

It is our view that a targeted review of the market would be beneficial to understand the complexities of an effective developer services market. In order to provide the most benefit, a review of the developer services market should focus on areas where there is a lower concentration of work carried out by third parties.

This approach will ensure that any market review would not be unduly onerous where the market is functioning well. This would mean that any review may focus more intently on areas and activities with lower levels of competitive activity.

The North West has a successful, well established competitive market for developer services where SLPs (Self-lay providers) and New Appointees operate and successfully compete. UUW has taken positive steps over many years to support an effective market in developer services. We have consistently high levels of SLP activity, and we have observed a rapidly maturing NAV market in the region in recent years.

Our focus is on contributing to the efficient operation of the developer services market so that it provides infrastructure of a good standard. Our priority is to ensure that the infrastructure built is of a good standard, and we continue to be agnostic as to the delivery mechanism.

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

We agree with the principle that companies include historical variances between expenditure and revenues in setting infrastructure charges where it is appropriate to do so. An example of this would be where network reinforcement expenditure has been accelerated or delayed. Historic variances should be considered in that context and intelligently used. This should mitigate the risk of developer customers potentially contributing twice for the same element of reinforcement should there be any delay in when network reinforcement expenditure is incurred and when charges are set.

It is important to provide bill stability for both developer customers and the wider customer base. In any given project lifecycle some slippage can be expected, this is no different for network reinforcement expenditure, which quite often is intrinsically part of other large supply and demand infrastructure projects. The ability to take into account appropriate historical variances when setting infrastructure charges could help mitigate bill volatility for customers, as this would be considered on an annual basis when setting charges.

It is important that the wording within the charging rules of any requirement to consider any under-recovery or over-recovery of infrastructure charge revenue in previous charging years is flexible enough to allow each company to make an appropriate assessment of when to adjust the infrastructure charge. Planned network reinforcement expenditure can be impacted by a number of factors including mobilisation of work and re-prioritisation of needs.

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

We agree with the proposal to enable companies to take account of upsized infrastructure when setting infrastructure charges. This is something we already take into account, where appropriate, when assessing the network reinforcement required and setting infrastructure charges.

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

We agree with the proposal to accommodate changes to the provision of income offset through the removal of the balance of charges rule.

We agree with the proposal to amend rules 5, 52, 55 and 57 to refer to income offset only in connection with existing agreements, recognising the expectation that the ability to offer income offset from 1 April 2025 for new agreements will be removed.

Following Ofwat's consultation on the scope and balance of developer charges and incentives in April 2021<sup>2</sup>, we began engagement with developers and SLPs on the potential impacts of this and the removal of the ability to pay income offset. Developers have previously stated that their preference is for stable and predictable charging arrangements and the importance of plenty of notice of any significant change. It was in the spirit of stability, predictability and transparency that discussion was begun on the potential removal of income offset to spread awareness and allow them to build this risk into their plans.

In the guidance to companies on submitting PR24 business plan tables (May 2023)<sup>3</sup>, Ofwat clarified that it would not expect companies to enter into any new agreements in the remainder of AMP7

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<sup>2</sup> <https://www.ofwat.gov.uk/wp-content/uploads/2021/04/Balance-of-charges-consultation.pdf>

<sup>3</sup> <https://www.ofwat.gov.uk/wp-content/uploads/2023/04/PR24-BP-table-guidance-part-8-Developer-servicesV4.pdf>

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that would require them to make any payments in connection with income offset after April 2025. We have factored this into our transition plan as we continue to engage with developers and SLPs sharing our intended approach.

On 11 October 2023 we held our annual developer conference, which continues to be well attended by developers, SLPs and industry consultants. We outlined our proposed transition for the removal of income offset across different agreement dates. During this session we asked developer customers if they understand how the removal of income offset will impact their developments from 1 April 2025. We received a positive response, with 88% confirming yes, with no specific queries raised on our proposed approach. We will continue to share transition plans at future engagement events as well as using other communication media.

We recognise that developer customers in our region will be disproportionately affected by the removal of income offset. Our active and ongoing stakeholder engagement is a key element of the handling strategy we have implemented to manage the impact on developer customers.

**27 October 2023**