

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Yorkshire Water
Western House
Halifax Road
Bradford
West Yorkshire
BD6 2SZ

By email: charging@ofwat.gov.uk

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Dear Ofwat,

RE: Consultation – ‘Changing Ofwat’s charging rules to support the new developer services framework’

Thank you for the opportunity to review and respond to the consultation issued in August 2023 on the changes Ofwat wishes to make to its new connection charging rules for English water companies, to be effective from April 2025. The changes proposed aim to complement the deregulation of certain aspects of developer services that Ofwat will implement as part of its price review 2024 (PR24).

Yorkshire Water is broadly supportive of the portfolio of changes proposed both where the changes are set to enact some deregulation of incumbents’ developer services and those intended to protect customers in the market who cannot exercise the full range of choices and may be using the services of incumbent companies effectively as a supplier of last resort.

We are encouraged by Ofwat’s novel concept of applying unit price ratios to how companies set charges between typical developments of different sizes to ensure a level of price protection can be put in place for segments of the market (single and small developments) that do not enjoy high levels of competition and are therefore much more likely to need to use the full range of developer services of incumbent companies. We make some suggestions on how this ‘tethering’ approach could be further refined to mitigate the potential volatility across infrastructure charges in AMP8.

We also welcome Ofwat's plans to allow companies to take both an historical and forward-looking view of network reinforcement expenditures when setting infrastructure charges to levy upon developers, SLPs, and NAVs. We have asked for this approach in the past and are happy this could soon be actionable. We would welcome some clarity and direction from Ofwat on how companies should accommodate the customer cost sharing approach to manage uncertainty for network reinforcement expenditures to 'allowed revenues' inside the price controls set at the PR24 Final Determinations, and any consequential effects on the setting of infrastructure charges for developer customers.

We believe some of the changes proposed may result in further creep in the regulatory burden of reporting by incumbent companies, both in relation to specific developer services publications, but also in the APR. We will wait to see what further details from Ofwat confirm and the format these will take.

Appended to this letter, I provide detailed feedback from Yorkshire Water to the questions raised in the consultation and observations on the proposed changes to new connections charging rules.

We look forward to Ofwat's next iteration of proposals and draft text changes to the charging rules in the next few months. In the meantime, we would be happy to discuss our thoughts further with Ofwat before it finalises the revised charging rules in 2024.

We also look forward to the enhanced guidance for companies that Ofwat proposes to make via its Regulatory Accounting Guidelines on how to allocate overhead costs to developer services (described as Option 7. in the consultation).

Should you have any questions about our consultation response, please let me know.

Yours faithfully,



Head of Regulation, Yorkshire Water

Yorkshire Water response to the consultation – ‘Changing Ofwat’s charging rules to support the new developer services framework’.

General Observations:

- i. Ofwat refers in its consultation document to the Charges Scheme Rules (CSR) issued under sections 143(6A) and 143(B) of the Water Industry Act 1991, and that the CSR define how Infrastructure Charges should be set by companies. However, the CSR no longer carries these clauses having been updated in April 2023 (rules 26–35 having been removed). The Charging Rules for New Connection Services for English Companies now detail how Infrastructure Charges are to be set (rules 50–58).
- ii. Within the **‘Draft’ changes to the charging rules in Appendix 1**, we are interested to know why under the proposed changes to rule 52, Ofwat has reinstated the phrase highlighted in *red italics* below, which was previously struck through in Ofwat’s October 2021 issue of the charging rules:

“and in calculating these costs 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, less any other amounts that the relevant undertaker receives for Network Reinforcement; and”*

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 have reviewed the options provided by Ofwat in the consultation to change and adapt its new connections charging rules and associated interventions. We are encouraged by Ofwat’s preferred option 4, to offer a level of price protection for customers who do not enjoy the benefits of high levels of competition in the market. Through ‘tethering’ together the future maximum bill sizes of different ‘typical’ development scenarios, Ofwat intends to keep the relative prices across

different segments of the market within a reasonable range, based on current price differentials.

As we understand the tethering mechanism described, this should have the effect of creating a 'no worse off' relative price position for developers who are making single or small numbers of connections when compared to developers connecting medium and large developments using the incumbents services – i.e. the ratio between the future unit charges set by the water company (charge per connection) for single and small developments to medium and large developments could not exceed the tether ratio as determined and published by Ofwat.

As the level of new connections charges may change over time 'tethering' the typical development bill scenarios could help ensure different sized developments do not face extreme charge increases or decreases when compared to other sizes of developments. Water companies could instigate charge changes that are required to reflect their costs for the relevant services, but the overall tether ratio constraint would act as a limiting cap to protect smaller developer customers who have less choice in the market currently. It is clear of course that incumbent companies should follow all existing aspects of the new connections charging rules and continue to set their charges that reflect the costs of the services provided for the customers who are in receipt of these services aligned also to the principles of fairness and transparency. The tether ratio approach should not become a trigger or target for the delta between the level of charges applied for small developments compared to larger developments.

In principle we support Ofwat's approach and think there is value in considering:

- how the common tether ratios are determined, and
- how they would be monitored and amended over time.

How are the tether ratios determined?

As presented, Ofwat intends to set the tether ratio's that shall not be exceeded based on the maximum ratios of unit charges per connection across all English companies for the charge year 2023-24.

Ofwat uses four of the scenarios defined in its Common Terms and Worked Examples publication which places a requirement on companies to publish example bills for a range of typical development scenarios. Ofwat then removes

the effect of any company income offsetting from these bill scenarios as the ability for companies to offer offsetting will cease from April 2025 and presents the values on a unit charge per connection basis. The highest ratios from these adjusted 2023–24 bill scenarios on a unit charge per connection basis are then selected as the tether ratio cap intended to apply to all companies charges from 2025–26 charge year onwards.

Using the maximum ratios from 2023–24 charges

To ensure companies have the necessary latitude to adjust their future individual charges appropriately, we agree with Ofwat’s proposal to select the maximum ratios from its bill scenario comparative assessment to set the tether ratio caps that would apply to 2025–26 charge year onwards.

However, we would like Ofwat to consider setting the maximum tether ratios based on a comparative assessment of the charge scenario differentials with **infrastructure charges excluded** from the typical bill values. Infrastructure charges set to recover ‘wholesale’ reinforcement expenditures that will remain within the network price controls for AMP8 do not reflect the efficiency and prices of core contestable and non-contestable developer services activities delivered by companies.

We also expect infrastructure charges will be more volatile in AMP8 and beyond in order to recover increasing network reinforcement investments that are required across AMP8 (as reflected in some companies PR24 Business Plans). If we also consider the likelihood of the need for additional funding via infrastructure charges for increased financial incentivisation for developers to build more sustainable new housing in future, then we would anticipate a step change in the level of infrastructure charges being applied by many companies to their developer customers, SLP’s and NAVs. This may lead to tether ratio’s being set based on historical charge levels, not being most appropriate for limiting price differentials for different sized developments into AMP8.

We therefore encourage Ofwat to consider rerunning its comparative charge analysis (as shown in Tables 2 and 3 of the consultation), but this time exclude water and wastewater related infrastructure charges from the 2023–24 charge year scenarios across each company.

Option 3 – capping net margins

We would welcome more feedback from Ofwat on why it has discounted the option 3 – capping net margins – from being pursued. Ofwat says this approach could –

“... encourage companies to re-allocate costs from the contested to uncontested market.”

Based on the principle that charges should reflect the costs of the relevant services, we believe only fair and appropriate overhead cost allocations should prevail. Otherwise, Ofwat may be implying companies would otherwise mis-allocate costs that would incorrectly benefit customers with large developments and disadvantage customers with small developments.

It remains important for companies to plan to recover their reasonable and efficient overheads and fixed costs that are hard to shed in the face of volume uncertainty over time (whether that uncertainty is driven through competition or wider market volatility or both). There may be pressure for companies to consider how to address this challenge, irrespective of whether there is a discrete cap set on their achieved net margins from developer services related activities (for expenditures and revenues that will be outside price controls).

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 welcome greater transparency in charges across companies where the aim is to provide consistent visibility of the level of charges for separate activities. We believe transparency where the activities are quite discrete will benefit both developer customers and customers that compete with incumbent water companies regionally.

However, we would caution against increasing price granularity where we risk the artificial unbundling of sub-activities that are commonly within a single service and are seldom delivered separately. There may still be a moderate justification in presenting greater price visibility in worked example publications under the CTWE definitions and templates, where the breakdown in the worked examples may not translate through to the same breakdown in the charge publications that list the unit rates for activities delivered by the incumbent company and form the

basis of fixed price quotations for real development projects. For example, the charges related to the provision and installation of a meter may be broken out further when presented in the worked example scenarios, but could remain as a single activity under a single unit price for the supply and fitting of a meter at a new connection within charges publications and actual quotations.

The approach we suggest could provide Ofwat and market competitors and developers with an opportunity to compare 'price' components across incumbents – which may be useful context. However, as incumbents do not compete against each other it may be unnecessary for a developer when they compare the best commercial packages for them for a specific site (when they compare the relevant monopoly incumbent with one or more SLP's and/or SLP/NAV partnerships).

Although not all incumbent companies are likely to face the same risks and opportunities around further unbundling of their charges for specific service lines, many companies may not find it straightforward to break out sub-activities into discrete chargeable items. Challenges may include for example, where a company's commercial arrangements with their supply chain partner provider does not already provide for that granularity of costs. Reopening of commercial frameworks mid-way through their planned lifecycle could trigger the risks of increases to schedule of rates in aggregate that would ultimately need to feed through into higher charges for developer customers.

We would welcome further opportunities to discuss with Ofwat its plans under option 5 – further unbundling of charges – with a view to construct a framework of what price separation and visibility makes the most sense and offers the best value to developer customers, and what granularity would Ofwat like to see as a regulator monitoring incumbents' costs to revenues and the new connections market in general.

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?

Yorkshire Water is supportive of the addition of two further scenarios to the worked examples list and would be happy with the examples provided in the consultation – namely:

- a housing development of 5 properties that does not require new mains,
- a housing development of 25 properties that does not require new mains.

We are uncertain that the presentation of additional worked examples, in combination with the visibility of greater charge granularity proposed under option 5, would itself deliver extra price protections to customers at sites that did not require a new mains. The presentation of such information would allow developers and stakeholders to compare and contrast the prices for common service arrangements across incumbent companies in England, but an absence of detail around the legitimate drivers for material price differentials may still leave developers feeling confused.

We would welcome further information from Ofwat on how these new example scenarios would fit in with the tethering ratio's approach. And if Ofwat would accommodate these into the formation of future tethering ratio caps?

Even though both incumbent companies and NAVs act as local monopolies when it comes to the services they deliver to end consumers once new properties are occupied, we accept that the playing field continues to be skewed with respect to the mandatory publication of price information from incumbent companies compared to NAVs, who would consider their prices commercially sensitive.

Over time as competition for new connections and relative market shares come into balance, we would like Ofwat to consider reducing the regulatory burden it places on incumbent companies. We hope in time that Ofwat can see itself clear to row back on the level of publications it mandates companies to make beyond the new connection charging arrangements themselves. Companies could of course decide to continue to publish some worked examples and typical bill granularity information that their customers find useful.

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 greater clarity in the RAG2 is always welcome where the opportunity allows, and that detail will be consulted on so consequential factors or impacts can be considered before a change is adopted. We would support a statement that central and departmental overheads should be allocated in a fair manner with no discrimination.

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 note that Ofwat says it does not specify in detail how companies should allocate and recover overheads for developer services. We think Ofwat does to a significant degree stipulate or guide companies on overhead cost allocation for developer services in the same way it does for the other AMP7 'wholesale' controls. Indeed when it comes to the operating costs of regulation, Ofwat defines that 1/10th of these costs should be allocated to the Developer Services 'control' (1/6th of such costs for a water only company). A company's annual regulation expenditures will be a significant amount incorporating the regulators licence fees, CCW fees, the costs of operating its Regulation function including consultancy and assurance costs, etc.

How companies independently come to decisions on how best to recover such costs across a menu of charges to the market and their developer services customers can however be quite varied, as Ofwat references from the work it commissioned from Sia Partners. Although all companies will try their best to work within the principles laid out in Ofwat's charging rules, it is understandable that different approaches to the setting of charges have evolved.

Moving into AMP8 and the need to split of revenues and costs between inside and outside price controls, we would welcome additional guidance and direction from Ofwat on how the regulation costs allocations will be affected. In addition if any changes are to be proposed to the hierarchy of cost allocation approaches referenced in RAG2.09 currently. We envisage some of these approaches may not be optimal for the elements of developer services that will be outside the price controls with the allowed revenue restrictions, but facing an open market environment.

We would welcome a discussion with Ofwat about the potential for more prescription or direction on overhead recovery through charging rules, assuming Ofwat will continue to appropriately guide overhead allocation via RAG2. It remains up to a company's management to ensure their costs efficient and their charges are fair. With contestable developer services revenues and costs being moved outside the price controls, companies will face increased risks and pressures to ensure they strike the right balance with their developer customers and competitors over time.

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 do not offer a specific proposal at this stage on setting a different approach to the allocation of overhead costs (and by inference their respective recovery via charge setting) between developments with and without a new mains laying element.

We would stress that whatever options are considered by Ofwat, the need for an approach that delivers simplicity and consistency will be key. Again, as we note in our response to question 5, how companies determine their specific charges by activity and development characteristics can vary. This may not lead to recovery of overheads in the same manner companies are required to report costs.

In our engagement with many developer customers and stakeholders in the market, they are often confused by the level of complexity in companies' charges and the regulatory rules that have developed and changed over the years to address policy preferences and an increasingly competitive and dynamic new connections market. Incumbent water companies are one part of the market providing both statutory and contested services and our charge structures should not be directed to be overly complex that they are difficult to compare by customers to the alternative providers. We are not aware that this is of particular concern for our customers at present with how our charges are set and presented.

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

We would support Ofwat's proposal to carry out a review of the water and wastewater new connections market prior to PR29 and understand the nature of the market overall and markets regionally. We would welcome an appraisal of the effectiveness of the regulatory framework, including incentivisation mechanisms, within the review also.

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

Yes, we agree with the proposals that companies include historical variances between reinforcement expenditures incurred and revenues collecting in helping inform the setting of future infrastructure charges, alongside a forward-facing forecast of likely costs and activity levels (a forecast that is inherently difficult to do accurately). We believe this would also allow the sector to better meet government expectations that:

"The general customer base should not bear costs in relation to new development and developers should not bear costs associated with enhancements to the existing network that are not a consequence of their new connection."¹

We have long advocated for such an approach and believe it would help both customers and companies have greater trust in the level of charges and payments made to fund the reinforcement of network infrastructure in the round that is borne by developers rather than the generality of customers. As Yorkshire Water stated in its response to Ofwat's June 2021 consultation on updating the charging rules:

"... there is no direct regulatory mechanism we are aware of that would make adjustments to new connections charges to reconcile and remedy any under or over recovery of network reinforcement expenditures over the AMP7 period, whether that be in-period or end-of-period."

¹ – As laid out in Defra guidance to Ofwat for water and sewerage connection charges (2016)

As we noted earlier in this response, we anticipate the combination of increasing network enforcement expenditures driven through growth and the future incentivisation of developers to build more sustainable new homes, will drive greater infrastructure charge volatility. This reinforces the need to have some ability to reconcile actual expenditures and incentives funding with actual revenues billed/collected from infrastructure charges.

With the removal of income offsetting from 2025-26, we believe it will become easier for all companies to track and reconcile reinforcement and infrastructure charges to a reasonable degree over the longer term.

In addition, we note the reconciliation method for network plus price controls 'allowed revenues' to recover network reinforcement costs will change from the DSRA mechanism used for AMP7 to the company-customer cost sharing mechanism. This leaves the risk of under or over recoveries of revenues from infrastructure charges ² compared to 'allowed revenues' related to network reinforcement in the Final Determinations (i.e. what revenues can be retained by companies compared to what is collected from developers, SLPs, and NAVs) being shared between companies and the generality of their customers.

We believe this paradox will need to be considered by Ofwat before it sets out its plans to direct companies on how they should undertake an historical looking and forwards looking approach to setting their infrastructure charges, with the intention to resolve expenditure and revenue variances in network reinforcement. This could include revisions and clarifications on what companies should report in table 2K of the APR for AMP8.

Ofwat has provided in Appendix 1 of the consultation draft text for an amended rule 52 of its Charging Rules for New Connection Services that refers simply to adjusting the costs of network reinforcement for any under- or over-recovery of infrastructure charge revenue in previous charging years. To help deliver consistency in how companies approach this given the cost sharing mechanism for variances to allowed revenues inside the price control, Ofwat could provide an explanation of how any historical under- or over-recovery should be assessed to avoid any risks of double counting.

² - We expect the assessment of revenues from infrastructure charges to exclude the proportion of such revenues collected for the purpose of funding environmental incentive schemes for developers to build sustainable new homes under Ofwat's proposals that such schemes would be self-funded within the developer services customer base.

The charging rules should also provide clarity on how the Environmental Component (used to fund developer incentivisation) are treated in the historical under- or over- recovery of infrastructure charge revenue assessments.

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

Yes, we broadly agree with the principle that the reasonable costs of upsizing network infrastructure beyond that capacity first required to address current new connections growth, could be more readily recovered if included in the historically incurred costs under the backwards and forwards looking approach to setting infrastructure charges as proposed.

Care should be taken by companies that such an approach does not result in excessive upsizing of infrastructure that remains under-utilised for decades, where it could be foreseen that further demand for new connections at that locality was unlikely. The sensible move by Ofwat to protect companies where necessary and efficient upsizing costs are incurred, should not result in unnecessary upsizing costs being carried by future customers making connections across the region (where no customers actually receive the benefit from excessive upsizing).

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

We are broadly happy with the proposals relating to ending the provision of income offsets, set against infrastructure charges, from April 2025 onwards.

Given the intention outlined in the guidance to companies on submitting business plan tables for PR24 plans, that Ofwat does not expect companies to make any further agreements within AMP7 that include income offsetting, the updated rules, as drafted in Appendix 1 of this consultation, do not seem to reinforce that position and may still allow companies to make payments to developers as an income offset to infrastructure charges as long as the agreement was made prior to April 2025.

Although Yorkshire Water has not offered new income offsets under any agreements from 2018 onwards, we have made income offset payments for a number of years after 2018 where development sites had a long build profile over

many years. We believe ambiguity may remain on whether all offsetting must cease from April 2025 or that offsets may be settled after 2025 under historical agreements (or be dealt with/resolved with relevant customers prior to 2025 if part of an earlier agreement).
