Response to Ofwat's PR19 Draft Determination

Appendix

TW-DD-A14

Response to consultation on regulating Developer Services

30 August 2019

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Section 1

Response to consultation

A Introduction

1.1 We welcome the opportunity to respond to this consultation, which we consider to be in the interest of both companies and customers. We are in agreement with the changes proposed and have outlined our analysis of each topic and the options against each one below.

B Issue 1: Developer services end-of-period reconciliation

1.2 We recognise that the original intention in the PR19 Final Methodology was to allow companies to establish bandings for connections and capture unit rate information within each band. Your recommended approach to banding was based upon an assumption that the number of properties connected in each development was the fundamental cost driver, and that larger developments would have a cheaper unit rate.

1.3 We chose to band on the basis of the ground conditions in soft ground (potentially a proxy for green-field) v connections in hard ground (brown-field) as this is both the bigger driver of our costs and therefore revenue within our region and also that the green-field development sites are the area where there is significant penetration of self-lay activity. This cost differential is key in our contractor schedule of rates.

1.4 You have proposed three alternative options:

1) Retain the approach set out in our PR19 Final Methodology
2) Introduce a new, simpler approach to reconciliation
3) Introduce an Ofwat determined, multivariate approach to reconciliation

1.5 We agree that option 1 does not allow for comparative efficiency calculations and that there will be a cost given that the volume of funded household growth is no longer determined by company forecasts.

1.6 Option 2 is our preferred approach, as we believe that it inherently picks up company specific drivers of growth cost, it does however imply that changes in penetration of self-lay companies into the market are not taken into account within the price review period. We recognise that this would act as an incentive to companies to promote more self-lay activity but puts those companies who already have a higher level of self-lay at a disadvantage as they are less able to outperform the allowed costs.

1.7 Option 3 clearly does make allowances for self-lay penetration but the assumption that the variables to be captured in this model (length of mains, number of diversions, number of new connections and self-lay penetration) are the correct variables to model is untested. There may be other pertinent drivers such as the amount of traffic management and permitting required in each incumbent area, and regional cost factors that would also determine what the efficient costs should be for each company.

C Issue 2: Incentivising accurate developer services forecasts

1.8 Option 1 retains the approach set out in the PR19 Final Methodoogy.

1.9 Ofwat has decided to use their own forecast of growth in properties in AMP 7. This means that the allowed revenues are not based upon the companies forecasted property growth and this therefore negates the rationale for a reward or penalty based upon forecasting accuracy.

1.10 Option 2 Eliminate the developer services forecasting incentive and reinstate developer services back into the Revenue forecasting Incentive. **Option 2 is also our preferred option**. The determination will set allowed revenue per property for Developer services water and wastewater connections and will allow this revenue for the actual number of properties connected.

1.11 The modelling is simple to understand and communicate but we are not sure how it will deliver one of the benefits in the consultation. "including developer services within the RFI would create an incentive on companies to continue to engage with developers and forecast developer services demand during 2020-25." [page 12 of consultation] We would of course be doing this for our own planning purposes.

D Issue 3: Treatment of developer services in Ofwat's control

1.12 Ofwat has recognised a limitation to the methodology used in calculating allowed revenues from developer services. Namely that different companies apply different income offsets to Developers and the assumption that all companies included all developer services costs as enhancement expenditure (A number of companies, including Thames, considered diversion costs and operating costs for Developer Services as Opex as base rather than growth expenditure).

1.13 It is well documented in responses to recent charging consultations by external parties such as the HBF, and Fair water connections (Charging rules for new connections and new developments for English companies from April 2020 – decision document July 2019, Ofwat) that there are significant variances in the structure of company charging schemes in terms of size of income offsets and asset payments given.

1.14 The application of common recovery rates at the net Totex level has therefore created an uneven playing field in terms of allowed revenues. This is then reinforced by the insistence in charging rules (rule 19) that companies must maintain the balance of charges. Whilst we recognise that there is no direct link between the charges scheme and allowed revenues in PR19 it does seem odd that some companies are in effect given preferential treatment in allowed revenues compared to others.

1.15 The consultation proposes two options:

- Option 1: Retain the approach applied to fast track draft determinations
- Option 2: Alter the approach. This would be based upon forecasted Grants and Contributions of each company, with their own recovery rates applied.

For the reasons outlined above we prefer option 2.

E Issue 4: Treatment of diversions

1.16 In the fast track determinations Ofwat included all diversions income within the price control. The assumption was that base cost assessment models included historic diversion costs and therefore this was included. This approach would work if:

1) The data requested and collected in APP28 was structured to include all diversions income within the price control. It is clear from the figure below the s185 Diversions were to be included within the price controls (a change from AMP 6) and Thames included NRSWA and other diversions in line 12 (as per AMP 6 treatment).

Figure 1: Line titles from Block C of App28

C	Grants and contributions received - wholesale water services	
7	Connection charges (s45)	£m
8	Infrastructure charge receipts (s146)	£m
9	Requisitioned mains (s43, s55, s56)	£m
10	Other contributions (price control)	£m
11	Diversions (s185)	£m
12	Other contributions (non-price control)	£m
13	Total grants and contributions - wholesale water service	£m

Source: TW-DT01-NEW PR19-Business-plan-data-tables-Jan2019 TMS (NEW)

2) Companies applied a consistent approach to cost allocations for diversions in WS1,WWS1,WS2 and WWS2. The methodology used at Draft Determination has excluded any costs for Developer Services (including diversions) captured in Base tables, which is already inconsistent with the assumption made for fast track companies.

3) Diversions expenditure is stable over time. This is not the case since:

- There are a number of nationally significant infrastructure projects within our region which incur significant diversion costs and income. Such as, in our region, Crossrail, High Speed 2, M4 Smart Motorway, Heathrow expansion and Crossrail 2.
- S.185 diversions are consequential to land developments so increases in growth lead to increases in s.185 diversionary work.

1.17 There are two proposed options:

- Option 1: Retain the approach we applied to fast track companies draft determinations
- Option 2: Set non-section 185 diversions income outside of the price control.

1.18 Draft determinations for slow-track and significant scrutiny companies have already changed in methodology from the approach applied to fast track companies and Thames' had already interpreted non section 185 diversion income as outside of the price control so we therefore **support option 2.**