

Representations: Developer services

Document Reference: J008

This document contains UUW's representation on the draft determinations of the slow track and significant scrutiny water companies relating to the regulation of developer services.

United Utilities Water Limited



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Executive Summary

This document contains UUW's representation on Ofwat's approach to regulating Developer Services following Ofwat's July Draft Determinations of the slow track and significant scrutiny water companies.

This document also contains the supporting commentary to the data table.

Section 1 details our response to Ofwat's approach to assessing diversions income and expenditure.

Section 2 details our response to Ofwat's approach on the treatment of developer services.

Section 3 details our response to Ofwat's approach to the developer services end of period reconciliation.

Section 4 details our response to Ofwat's approach to Incentivising accurate developer services forecasts.

Section 5 provides the commentary to support the completed developer services data table (J008a) issued by Ofwat on 20 August 2019.

Section 6 lists the sources of the documents reference within this document (J008)

We note that Ofwat's July publications have addressed many of the comments made in response to our fast track draft determination in relation to grants and contributions, and Ofwat in its document "Our proposed approach to regulating developer services" on the proposed approach to regulating Developer Services.

In this response, we have clarified which issues now appear resolved, and which issues raised still require Ofwat's attention prior to publishing final determinations in December.

Diversions

In general, we are supportive of Ofwat's approach to regulating developer services. However, there remains an issue regarding the cost assessment of Diversions activities. On the conference call of 16 August, Ofwat indicated that it may deduct diversions costs from modelled base totex. This would significantly harm the ability of UUW to recover reasonable costs, as it has significant additional projected diversions (due, for example, to the expected requirements of HS2) compared with the "implicit allowance" within totex models. It is therefore very important that Ofwat accepts our proposed cost adjustment claim (as set out in our fast track DD response document D003d) to ensure that those reasonable additional costs are recognised in our final determination.

Our expected diversions gross expenditure across both the Water and Wastewater network plus price controls in AMP7 is £111.6m, and we forecast that we will receive £102.7m of diversions income for that activity. However, we estimate that the implicit allowance with Ofwat's botex models for diversions expenditure to be only £21.49m and therefore the net value of our claim, which needs to be added to the totex baseline, is £90.11m.

Revenue control

We believe that there are grounds for Ofwat to reconsider its approach to including developer services within the overall revenue control. We are concerned that the current focus on the developer and NAV markets may lead to further developments in charging rules and requirements applicable to those markets. It could be envisaged that some of these could cause

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the level of these revenues to deviate significantly from those set at the price control; this would likely be the effect, for example, of a future drive for more consistency in approach across all companies.

The knock on effects of such changes, when operating within a single overall revenue control, could cause undue harm to customers and/or the company. For this reason, we recommend that Ofwat reconsiders including developer revenues as part of an overall revenue control, unless Ofwat is confident that future changes to charging rules will not prevent companies from recovering revenues from developer services that are consistent with that component of the price control.

1. Treatment of diversions

Ofwat has identified two key issues with its approach to assessing diversions income and expenditure whereby (Ofwat, 2019 p. 16):

- *[Ofwat's] cost model does not allow [it] to project major jumps in diversions expenditure and,*
- *The expenditure is relatively unpredictable.*

The proposed solutions are to either:

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

Given these two options, we agree that Ofwat should adopt option 2, as retaining option 1 would lead to a significant financial risk, which is outside of management control, being included within the price control, to the potential detriment to both customers and the company. The party requesting the diversion accepts the costs of a diversion and therefore it is only right that the financial risk should also sit with them and not customers or the company.

We also confirm that we agree in principle with Ofwat's proposed licence condition B change to include non-section 185 diversions within "excluded charges" in paragraph 2 of Condition B and do not have any comments on the proposed definition.

Ongoing issue with diversions cost assessment

Although it is recognised by Ofwat in its "option 2" that contributions from NRSWA and HS2 related diversions should be outside of the revenue control this alone does not address the primary concern with diversions raised in our fast track DD response, which is that Ofwat's (implicit) assessment of cost for diversions is significantly less than the assumed income provided. Effectively, Ofwat has used inconsistent assumptions for diversions costs (implicit allowance from botex model) and diversions income (whereby Ofwat has used the, much higher, company forecast). Our expected diversions gross expenditure across both the Water and Wastewater network plus price controls in AMP7 is £111.6m, and we forecast that we will receive £102.7m of diversions income for that activity. However, we estimate that the implicit allowance with Ofwat's botex models for diversions expenditure to be only £21.49m and

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therefore the net value of our claim, which needs to be added to the totex baseline, is £90.11m. This implicit allowance was based on our approximation of industry diversions expenditure using the suite of cost models from IAP. We note that the additional information that Ofwat has sought regarding historic diversions expenditure should enable a more accurate view of the implicit allowance to be calculated using the new base+ models.

We raised a new cost adjustment claim as part of our fast track DD response (document D003d), which we expect that Ofwat will still need to recognise for the Final Determination, to ensure that it aligns its assumptions for the company's diversions cost requirements which are consistent with its forecast income. This point is also specifically picked up in our slow track DD response to cost assessment (document J003).

In support of this we have provided the requested diversion expenditure breakdown as part of the developer services data request (line items A1 to A4). The table is provided in (MS Excel) document J008a and the associated commentary in relation to diversions is included in section 5 below.

In summary, we propose that Ofwat:

- **should adopt option 2 and set non-section 185 diversions income outside of the price control.**

2. Treatment of developer services in our control

Ofwat has identified two key issues with its approach to calculating net totex (Ofwat, 2019 p. 13):

- *Misalignment with our developer services reconciliation,*
- *Perceived interactions with charging rules*

The proposed solutions are to either:

1. Retain the approach Ofwat applied to fast track companies' draft determinations.
2. Alter the approach to ensure a consistent approach between the data used for our calculation of net totex and the developer services reconciliation. In both cases, this would be based on grants and contributions gross revenue.

Given these two options, we agree that Ofwat should adopt option 2, as retaining option 1 and applying common Recovery Rates, where the income offset was capped, may restrict a company's ability to maintain the balance of charges between developers and customers in line with Ofwat's charging rules.

In summary, we propose that Ofwat:

- should adopt option 2 to ensure a consistent approach between the data used for the calculation of net totex and the developer services reconciliation.

3. Developer Services end-of period reconciliation:

Ofwat has identified three key issues with its approach to end-of period reconciliation (Ofwat, 2019 p. 6):

- *Cost challenge - [Ofwat considers] it is difficult to have a high degree of confidence in companies' unit rates for bands of developer services connections,*
- *Administrative burden - due to the number of disaggregated services companies have proposed, the end-of-period true up would be resource intensive for both companies and Ofwat,*
- *Cost reflectivity – some companies have not split their customers into customer groups in accordance with [Ofwat] guidance. This means that companies' allowed revenue could not be set to take account of their market share of developer services.*

The proposed solutions are to either:

1. Retain the approach set out in the PR19 Final Methodology.
2. Introduce a new, simpler approach to reconciliation. Under this approach [Ofwat] would introduce a simplified, reconciliation approach based on a common cost driver.
3. Introduce an Ofwat determined, multivariate approach to reconciliation. This would be similar to the option 2 in that [Ofwat] use common cost drivers across companies. However, under this approach [Ofwat] could use a number of cost drivers.

Given these three options, we agree that Ofwat should adopt option 2, as retaining option 1 makes comparative benchmarking less reliable and could result in a significant administrative burden. Whilst we acknowledge that option 3 could increase cost reflectivity, we consider that option 3 is more complex than the simple common cost driver approach proposed in option 2, and it may therefore be risky to implement at this late stage without fully understanding the risk of unintended consequences which may arise from this complexity.

We are supportive of the proposed option 2, to calculate the 'end of period' reconciliation based on total connection volumes and single overall company specific unit rates. As the starting point is volume based it seems reasonable that costs and income will vary proportionately as the forecast unit rate reflects the underlying assumed activity volumes completed by self-lay providers and those completed by U UW on behalf of the developer.

In its *regulating developer services* document Ofwat proposed the following for the end-of period reconciliation:

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- that instead of end-of period reconciliation based on individual variances (up to 10 ‘bands’ of connections) the model would calculate reconciliation based on total connection volumes and single overall forecast unit rate (£ per connection);
- that the unit rate would be updated to be include only price control diversions activity and instead of calculating variance against companies’ connection forecasts;
- the variance was proposed to be calculated against Ofwat’s forecast of connection volumes, based on Office for National Statistics (ONS) household growth rate projections; and
- the adjustment would be made to companies’ allowed revenue at PR24.

However we note that in the “Supplementary information for all companies – Grants and contributions” document issued by Ofwat on 12 August 2019 clarification has been provided on how Ofwat has calculated its view of how grants and contributions (G&C) values will be assessed for final determination.

We believe that the revised unit rates (before efficiency challenge) have been correctly calculated based on our September 18 submitted business plan app 28 revenue and connection volume data.

On this basis we are content to support the outcome from Ofwat’s revised approach but note that this different to the published July draft determinations for other water companies and we have assumed that the tables in the supplementary document replace both the unit rate and the forecast number of new connections in Annex 1 and 2 of the developer services technical appendix.

In summary, we propose that Ofwat:

- **should adopt option 2 to introduce a new, simpler approach to reconciliation based on a common cost driver.**

4. Incentivising accurate developer services forecasts

Ofwat has identified two key issues with its approach to incentivising reconciliation (Ofwat, 2019 p. 10):

- *Reduced relevance of companies’ forecasts. [Ofwat uses its] independent forecast of the cost drivers captured within our base cost models,*
- *Adverse interactions with the RFI. Some stakeholders have raised concerns that they might be penalised by the RFI if their developer service revenue was different from the allowed revenue.*

The proposed solutions are to either:

1. Retain the approach set out in the PR19 Final Methodology,
2. Eliminate the developer services forecasting incentive and reinstate developer services back into the Revenue Forecasting Incentive.

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Given these two options, we agree that Ofwat should adopt option 2, as it is simpler and removes the potential issue arising from Ofwat’s use of independent forecast for properties as the basis of the incentive mechanism.

Whilst we are supportive of the adoption of option 2 to reinstate developer services back into the Revenue Forecasting Incentive we also believe that there is a case for Ofwat to reconsider whether it is still appropriate to have developer services within the total revenue control rather than it being stand-alone.

We believe that there are grounds for Ofwat to reconsider its approach to including developer services within the overall revenue control. We are concerned that the current focus on the developer and NAV markets may lead to further developments in charging rules and requirements applicable to those markets. It could be envisaged that some of these could cause the level of these revenues to deviate significantly from those set at the price control; this would likely be the effect, for example, of a future drive for more consistency in approach across all companies.

The knock on effects of such changes, when operating within a single overall revenue control, could cause undue harm to customers and/or the company. For this reason, we recommend that Ofwat reconsiders including developer revenues as part of an overall revenue control, unless Ofwat is confident that future changes to charging rules will not prevent companies from recovering revenues from developer services that are consistent with that component of the price control.

In summary, we propose that Ofwat:

- **should adopt option 2 to eliminate the developer services forecasting incentive and reinstate developer services back into the Revenue Forecasting Incentive.**
- **reconsider its approach to including developer services within the overall revenue control.**

5. PR19 draft determinations: Developer Services data request:

Ofwat requested that we complete the Developer Services data query (consisting of a Water and a Wastewater data table) and submit it alongside our representations on the draft determination, as detailed below.

PR19 draft determinations: Developer services data request post draft determinations

In our 'PR19 draft determinations: Our proposed approach to regulating developer services' we explained that we would be requesting data to inform our developer services assessment for PR19.

For the completion of these tables, please see the follow up guidance provided in the accompanying document 'Developer_services_call_160819_follow_up'.

Could you please complete the attached developer services data query. This data request is an evolution of the data requested in table App28. It has been compiled following suggestions in company responses to the queries we sent to all companies in April 2019 and a call with all companies in 16 August 2019. For completeness, some of the items in that April request have been repeated here.

This data will assist us in applying our intended approach to regulating developer services, as set out in our technical appendix titled 'PR19 draft determinations: Our proposed approach to regulating developer services'.

In the excel table values should be entered into the yellow input cells. The blue cells contain calculations.

Date sent to companies: 20th August 2019

The completed table and associated commentary should be submitted as part of your representations on the draft determination.

The following commentary supports the tables, highlighting the key assumptions applied. For ease of reconciliation to our original submission we have left the FY19 and FY20 values unchanged. Whilst there has been some movement between these two years we do not expect any material impact on forecast values across AMP7. Therefore, we have not included updated APR data within the revised tables.

The inflation assumptions applied to 2018-19 and 2019-20 to convert the cost and income values into nominal terms from 2017-18 prices are unchanged from the inflation assumptions used in our PR19 Business Plan submission in September 2018, as follows (cumulative RPI FYA);

- 2018-19 inflation assumption: 3.43%
- 2019-20 inflation assumption: 6.66%

Block A Diversions – Water and Wastewater

We can confirm that Ofwat's working assumption is correct, that diversions costs are reported on a gross basis (i.e. before income is netted off) in the data used to develop the base econometric models, which covered the period 2011-12 to 2017-18 at draft determinations. Please note that we initially reported net IRE within the business plan data tables as the inputs for the financial model (at the time) did not accommodate separate expenditure and incomes for diversions. We subsequently provided this additional data in our IAP Response in February 2019. We have also represented costs inclusive of gross diversions costs in tables WS1 and WWS1 in Document J003b with this submission.

Block A1 Diversions expenditure – Water and Wastewater (Lines 1 – 4)

Historic diversions expenditure information (2011-12 to 2017-18) has been taken from underlying data supporting the Annual Performance Reports (Table 4D Water and Table 4E Wastewater) for the respective years. Forecast information (2018-19 to 2024-25) remains unchanged from our PR19 Business Plan submission in September 2018. The values reported for AMP7 are also aligned with the values stated within our Special Factor Claim (Document Reference: D003d, from our Fast Track DD Response).

Block A2 Diversions income – Water and Wastewater (Lines 5 – 8)

Historic diversions income information (2011-12 to 2017-18) agrees to the Annual Performance Reports (Table 2E) for the respective years. Forecast information (2018-19 to 2024-25), remains

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unchanged from our PR19 Business Plan submission in September 2018. The values reported for AMP7 are also aligned with the values stated within our Special Factor Claim (Document Reference: D003d, from our Fast Track DD Response).

We note that for NRSWA diversions we are bound by the legislation set out in The Street Works (Sharing of Costs of Works) (England) Regulations 2000, which states that (emphasis added)¹:

“Diversionary works executed by an undertaker because of an authority’s major works

3.—(1) Where, because of major works initiated by an authority, an undertaker executes diversionary works, the authority shall pay to the undertaker—

- a) where the major works are major transport works (other than major bridge works or section 86(3) (a) to (g) works) and payment is made in accordance with regulation 8(1), a sum equal to **92.5 per cent.** of the allowable costs of the diversionary works;*
 - b) in other cases where payment is made in accordance with regulation 8(1), **a sum equal to 82 per cent.** of the allowable costs of the diversionary works;*
 - c) in all other cases, the allowable costs of the diversionary works.*
- (2) This regulation is subject to regulation 6.”*

This legislation results in a small amount of the costs incurred being passed on to customers. In completion of this Data Request;

- **s185** income and expenditure for AMP7 are equal (Line 1 and Line 5 of this Data Request), illustrating the full recovery of costs incurred
- **NRSWA** income and expenditure for AMP7 are not equal (Line 2 and Line 6 of this Data Request), illustrating the residual expenditure that is required to be recovered from customers for NRSWA activities (due to legislation)
- **Other non-s185** (relates solely to HS2) income and expenditure for AMP7 are equal (Line 3 and Line 7 of this Data Request), illustrating the full recovery of costs incurred. HS2 been recognised as “other diversionary works (e.g. not s185 or NRSWA diversion works)”, since these diversions are not being completed to serve new developments as they are solely being carried out to enable the new road / rail infrastructure to be installed.

Block B Connections volume data – Water and Wastewater

Lines 9 – 11: In data request U UW_DD_CE_004 (May 19) for number of connections, U UW reported the same number as the number of properties - as per the definition Ofwat applied to connections, as that was expected to reconcile back to App 28 lines 1 & 2 (water) and lines 17 & 18 (wastewater).

As this no longer appears to be a requirement, based on the *Developer Services conference call: follow up note* (from 20 August 2019), we have now populated this Data Request with actual connection volumes for the historic years (2011-12 to 2017-18) on lines 9 – 11 accordingly.

With regards to the forecast information (2018-19 to 2024-25), the connection volumes have been driven from the properties volume data, based on the historic analysis performed for completion of Lines 9 – 11 (Connections volumes) and Lines 18 – 20 (Properties volumes), we have identified that across the 7 year historic period (2011-12 to 2017-18), residential connection

¹ http://www.legislation.gov.uk/uksi/2000/3314/pdfs/uksi_20003314_en.pdf, page 2

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volumes were 84.71% of the volumes of properties connected and business connection volumes were 92.30% of the volumes of properties connected. This is due to bulk metered supplies where there may be one connection for multiple properties, e.g. flats. We have applied this % assumption to the property volumes data from Block C, Lines 18 and 19, in order to populate Block B, Lines 9 and 10. Block B, Line 11 is a calculated row.

Line 12: For Water, we show no connections as the limited NAV site connections that exist currently have been connected prior to 2011-12. For Wastewater, we have included the two NAV sites connected in 2017-18. We are forecasting no new NAV sites for the period up to 2024-25 based on the information available to us to date.

Lines 14 – 17: We have identified which connections were made on schemes where SLP's/developers undertook a significant proportion of the work and those where U UW undertook a significant proportion of the work and have populated lines 14 – 17 accordingly.

We have split our connections volume data between those schemes where SLPs/developers carry out >75% of the contestable activities (Line 14) and those schemes where U UW carry out >75% of the contestable activities (Line 16). We do not believe we have any connections which fall into the middle category (Line 15).

Block C Properties volume data – Water and Wastewater

Lines 18 – 20: Historic property volume data (2011-12 to 2017-18) has been taken from underlying data supporting the Annual Performance Reports (Table 7 Water and Table 13 Wastewater) for the respective years. Forecast information (2018-19 to 2024-25) remains unchanged from our PR19 Business Plan submission in September 2018 in total.

Lines 21 – 23: These volumes for Water and Wastewater have been based on actual properties connected data for historic years (2011-12 to 2017-18) and forecast properties connected data for future years (2018-19 to 2024-25). The forecasts have been taken from the data published in the NAV's Water Resource Management Plans (in the case of Water supplies) or our expected date of fitting meters (in the case of Sewerage only supplies).

Line 24: Sum of Lines 20 and 23

Lines 25 – 28: Previously submitted data in U UW_DD_CE_004 for 2015-16 to 2017-18 used an assumed split of property volumes between schemes where SLP's/developers undertook a significant proportion of the work (Line 25) and those where U UW undertook a significant proportion of the work (Line 27) based on an AMP7 forecast view. We have now pulled out the actual split of property volumes for all historic years and have populated lines 25 – 28 accordingly.

We have split our properties volume data between those schemes where SLPs/developers carry out >75% of the contestable activities (Line 25) and those schemes where U UW carry out >75% of the contestable activities (Line 27). We do not believe we have any properties which fall into the middle category (Line 26).

Block D Total cost of contestable activities – Water and Wastewater

Lines 29 – 31: Historic direct costs of contestable activities (2011-12 to 2017-18) has been taken from underlying data supporting the Annual Performance Reports (Table 4D Water and Table 4E Wastewater) for the respective years. Forecast information (2018-19 to 2024-25) remains unchanged from our PR19 Business Plan submission in September 2018.

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We have split our direct costs between those incurred on schemes where SLPs/developers carry out >75% of the contestable activities (Line 29) and those incurred on schemes where U UW carry out >75% of the contestable activities (Line 31). We do not believe we have any costs which fall into the middle category (Line 30).

Lines 32 – 34: Historic asset value payments (2011-12 to 2017-18) have been taken from underlying data supporting the Annual Performance Reports (Table 4D Water and Table 4E Wastewater) for the respective years. Forecast information (2018-19 to 2024-25) remains unchanged from our PR19 Business Plan submission in September 2018. All asset payments are made on schemes where SLP's/developers undertook a significant proportion of the work (Line 32).

In respect of the Asset Payment value being £nil in AMP7 for water, Ofwat's new charging rules state that the income offset allowance should be paid against infrastructure charge receipts in AMP7. This treatment was factored into our PR19 submission. On 1 April 2020, we expect to have a number of SLP mains laying schemes (total value £4.7m over AMP7) in progress which we have not yet paid out "asset payments" under the old rules, i.e. the scheme's income offset allowance has been quoted subject to an "asset payment" calculation using the DADS model.

These schemes are expected to complete within 2020-21 (£2.8m) and 2021-22 (£1.9m). Since these schemes will complete within AMP7, and Ofwat's new charging rules state that the income offset allowance should be accounted for against the infrastructure charge receipts in AMP7, our assumption is that this will also be the case for old, "in-flight" schemes such as those described above.

For completeness and transparency, the table below sets out the remaining legacy (DADS based) asset payments against the asset value payments (Line 32). In our submitted table, and consistent with our previous App 28 submissions, the values in 2020-21 (£2.8m) and 2021-22 (£1.9m) are included as part of Line 38 in Block E (total value of income offset allowances) and hence also netting off against infrastructure charge receipts in Line 36.

No Asset Payments are made in respect of wastewater.

Line description	Units	DPs	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2020-25
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Price base	Outturn (nominal)	2017-18 FYA (CPIH deflated)
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D	Total cost of contestable activities (£m)	Units	DPs	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2020-25
32	Asset value payments for new connections where self-lay providers/developers a significant proportion of contestable activity (more than 75% of contestable activity)	£m	3	21.667	22.739	2.848	1.899	0.000	0.000	0.000	4.747

Line 35: Sum of Lines 29 and 34

Block E App 28 data – Water and Wastewater

Lines 36 – 37: Historic income information (2011-12 to 2017-18) agrees to the Annual Performance Reports (Table 2E) for the respective years. Forecast information (2018-19 to 2024-25), remains unchanged from our PR19 Business Plan submission in September 2018.

Line 38: Historic income offset allowance information (2011-12 to 2017-18) is consistent with information reported in the Annual Performance Reports for the respective years, although we recognise it is not directly observable from the Annual Performance Report data tables. Forecast information (2018-19 to 2024-25), remains unchanged from our PR19 Business Plan submission in September 2018. We note that the income offset allowances for water also include £4.7m for the old rules “in-flight” schemes noted in the Lines 32 – 34 section above.

6. References

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