Developer Services – Yorkshire Water Draft Determination Representation

YorkshireWater

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Yorkshire Water response to Ofwat's proposed approach to regulating developer services

1. Overview

This paper is the response from Yorkshire Water to Ofwat's proposed approach to regulating developer services in Price Review 2019 (PR19), published on 18 July 2019 as a technical appendix[1] to its Draft Determinations for slow track and significant scrutiny companies.

We note the new proposals outlined by Ofwat in its technical appendix:

- have not been reflected in the Draft Determinations as they are subject to further work and require additional data and agreement from companies.
- will be applied to all companies in their Final Determinations (considering late evidence submitted after 1 April 2019).

We address Ofwat's proposals in the order presented in its technical appendix, covering four areas:

- the developer services end-of-period reconciliation (section 2).
- incentivising accurate developer services forecasts (section 3).
- the treatment of developer services in the revenue control (section 4).
- the treatment of diversions (section 5).

We welcome Ofwat re-examining its approach to regulating developer services under the Price Review in order to address issues raised to it by stakeholders and its own evolving view of how it models developer services related costs.

Before detailing our feedback on the proposed approach, we confirm we are broadly supportive of Ofwat's stated aims for its proposals to:

- "strengthen customer protections by reducing the risk that companies are allowed too much revenue and ensure risk is allocated appropriately whilst allowing an appropriate efficiency challenge".

[1] PR19 draft determinations - Our proposed approach to regulating developer services.

- "ensure its approach is internally consistent taking into account its cost assessment, end-of-period reconciliation, forecasting incentives and new connection charging rules".
- "simplify the setting, monitoring and reconciling of developer services activities".

We also confirm we have completed and provided the developer services data request made by Ofwat along with the draft determination and subsequently revised on 20 August 2019.

The following sections will consider the four areas where Ofwat propose to make changes at Final Determination.

2. Developer services end-of-period reconciliation

In section 2 of the technical appendix, Ofwat reviews its planned approach to introduce a volume-based symmetric revenue correction for developer services within a total revenue control (water network plus and wastewater network plus controls respectively) and presents alternative proposals. The approach detailed in its PR19 Final Methodology was designed to encourage timely and quality new connections to ensure developers receive good customer service.

Recognising that developer services costs and average revenues can be materially influenced by development type and size, the approach was to determine expected costs and average revenues across up to ten bands for connections for each network plus control. After reviewing all companies' business plans, Ofwat now consider it is difficult to have a high degree of confidence in companies unit rates across the different bands for connections, making comparative benchmarking less reliable.

As a further change from its approach at the initial assessment of plans stage, Ofwat is now modelling the costs associated with new connections with base costs.

Overall the approach outlined in its PR19 Final Methodology (termed Option 1) is considered complex with several issues likely to impact its effective application. Ofwat now presents two additional options:

Option 2: Introduce a new, simpler approach to reconciliation based on a common cost driver. This would generate a single company-specific unit rate variable for each year of the AMP7 period. Ofwat considers that a company-specific unit rate would reflect the unique characteristics of the company, such as the degree of self-lay penetration, mix of development types, etc. Option 2 is Ofwat's preferred approach as is more closely aligned to its latest cost modelling approach and will make the reconciliation of the price control less burdensome than Options 1 or 3.

Option 3: Introduce an Ofwat determined, multivariate approach to reconciliation. This is a refinement of Option 2, using a number of cost drivers to set company-specific unit rates, for example, length of new mains, number of diversions, number of new connections and self-lay penetration for different bands of developer services connections. It is considered more complex.

2.1. Our feedback

Ofwat has changed its approach to modelling costs for new connections in base costs for PR19, and we therefore welcome a review of how the reconciliation of the price control will operate. We note the low administrative burden of Option 2 for Ofwat and companies and the simplicity of using a single company-specific unit rate.

However, we remain concerned that the new approach detailed in the technical appendix under Option 2 may create reconciliation risks for customers and companies. The characteristics of the new connections market make it difficult for companies to forecast some cost drivers with any reasonable degree of certainty for the complete AMP7 period.

We believe the reconciliation approach as laid out for creating company-specific unit rates in 2019 at Final Determination for the 2020-25 period, to be applied through the new Developer Services Revenue Adjustment factor (DSRA), could impact customers disproportionately. The DSRA factor is determined using the company forecasts of grants and contributions for each charging year and the differential of forecast and actual new properties connected. Grants and contributions revenues are influenced by dynamic drivers, such as diversion costs and revenues, self-lay market share, NAV market-share, and the pace of property growth in the region.

Diversions can be materially affected by the plans for, and rollout of, regionally and nationally important infrastructure, that may be atypical in nature and scale. The market penetration by non-incumbent market participants is driven by the success of the strategies of those participants and the successful removal of any market frictions that may exist.

We have concerns that the use of an Ofwat forecast for the number of new connected properties for each company, based on household growth projections from the Office of National Statistics (ONS), may have unintended negative impacts on customers. The illustrative Ofwat forecasts for water and wastewater new connections for Yorkshire Water in the annex of the technical appendix are significantly lower than our reported historic averages, yet ONS projections show consistent growth across the region. Where much higher actual new connection numbers materialise, the subsequent end of period reconciliation may be a driver for higher bills for future customers in PR24.

We would welcome discussion with Ofwat ahead of the Final Determinations about how the calculation of the DSRA and the unit rates at Final Determination could be further improved through the inclusion of more up to date company forecasts throughout AMP7.

We note Ofwat's preference to apply adjustments to companies' allowed revenues at PR24. As developer services expenditure is capital, we suggest that reconciliation adjustments at PR24 are applied to the RCV. This would also allow reconciliation impacts for future customers to be smoothed over a longer period.

3. Incentivising accurate developer services forecasts

In section 3 of the technical appendix, Ofwat reviews its planned approach to incentivise companies to accurately forecast new connections numbers and collect the right amount of revenues and protect customers from unnecessary bill volatility. In its PR19 methodology Ofwat decided to not include developer services in its Revenue Forecasting Incentive (RFI), rather to introduce a developer services specific incentive on companies to accurately forecast new connection numbers across the 2020-25 period.

Ofwat's new proposals on how it will run end-of-period reconciliations, using its own forecasts of companies' future new connections based on ONS household projections, effectively weakens the rationale of the intended company forecast incentive.

Ofwat propose to move forward with a different approach under a new **Option 2**, reinstating developer services back into the RFI.

The proposed RFI approach relies on the application of in-period revenue adjustments across all price controls based on Final Determination forecast revenues.

3.1. Our feedback

We do not support the proposed inclusion of developer services into the Revenue Forecasting Incentive mechanism. We believe it would not be beneficial to customers in the long term and submit that the RFI should only be used to monitor and adjust Main Charges Revenues which are contained within the Wholesale Revenue Controls.

Under Ofwat's proposed approach to reconciling developer services revenues at the end of the period, based on its own forecasts of new connection numbers, the forecast revenues may be significantly different to actual revenues both in-period and over the whole period. As we noted in our feedback in section 2.1 of this document, we believe Ofwat's illustrative new connection numbers forecasts to be well below our historic levels, and this will result in a forecast revenue profile across AMP7 that risks being materially different to actual revenues collected from developer services customers over the period.

It is of note that those revenues are driven by actual activity levels against a number of changeable drivers using cost-reflective charges that comply with well-defined charging rules. Yorkshire Water has demonstrated its overall developer services expenditures and revenues are in balance [2], and our charges have been, and will continue to be, set to maintain that balance. We are not reliant on income offsetting to maintain that balance.

The new connections market is becoming ever more dynamic both in our region and more widely. The forecasting of company revenues in this market is more complex and less certain than for revenues collected directly for services delivered to the generality of customers. However, treating developer services revenues in the same way under a single RFI mechanism may expose the generality of customers to the financial incentive effects.

We feel that Developer Services charges should be monitored using models that will reflect the true impact of the movements of actuals to forecast values. We would like to work with Ofwat to develop these models.

We understand that the models need to be developed in a way which does not lead to additional regulatory burden, however they do need to take into account the change in demand from forecasts, the impact of the capital expenditure and should ensure that any resulting true ups should take into account the actual accounting for the items.

To help Ofwat retain a persuasive financial incentive for companies around either forecasting new connection activity levels or the related developer services revenues, we would like to work with Ofwat and other companies over the autumn to make improvements to a standalone developer services specific incentive that suitably accounts for the variability of activity in this market.

4. Treatment of developer services in the control

In section 4 of the technical appendix, Ofwat reviews its method for calculating net totex to ensure consistency with the developer services reconciliation approach now proposed for Final Determination.

Ofwat propose to move to base both net totex and reconciliation of revenues on grants and contributions gross revenue. Ofwat contend this is a better estimate of companies' costs associated with developer services (excluding any income offsets).

[2] Yorkshire Water assessing the balance of developer charges and setting infrastructure charges

4.1. Our feedback

Yorkshire Water no longer include income offsets and asset payments in the charging arrangements for new connection services following our removal of them from our 2018-19 charges. We do continue to honour such payments under the previous charging regime where developer services customers accepted a quotation issued prior to the change in our charging approach (Ofwat will see evidence of this in our data request submission accompanying this paper).

Subject to the points made in Section 2 above, we are broadly supportive of Ofwat's proposed updated approach as it will ensure consistency in calculating net totex for fast track, slow track and significant scrutiny companies.

5. Treatment of diversions

In section 5 of the technical appendix, Ofwat reviews its approach to including all diversions income within the price control.

Ofwat used historical diversions costs to produce a view of efficient allowances for diversions related base costs. However, its approach did not consider expected major jumps in diversions expenditure that are forecast for AMP7 driven by large nationally important infrastructure projects, such as HS2. The level of expenditure associated with future non-section 185 diversions is also relatively unpredictable. Should Ofwat establish a central estimate for this type of expenditure, actual expenditure could be significantly different, exposing customers and companies to financial risk.

Ofwat outlines an **Option 1** where it retains all diversions income within the price control and subject all price control grants and contributions to an end-of-period true up and exclude it from net totex cost sharing. Water companies would then bear the full difference between the forecast and actual cost of diversions. An alternative way of implementing this option would be to include diversion costs within net totex with both customers and companies bearing a share of the difference between forecast and actuals costs for diversions over the AMP7 period.

Ofwat also presents an **Option 2**, where all non-section 185 diversions income will be outside the price control, as an 'Excluded Charge'. Water companies would have to bear the full risk of deviations in diversion costs but would be able to retain the full revenue related to them.

Ofwat considers Option 2 as more favourable for customers in terms of the balance of benefits and risks, whilst recognising the overall incentive for cost efficiency is weaker in Option 2 than under Option 1.

To give effect to its proposals ahead of Final Determination, Ofwat is consulting on whether the list of Excluded Charges for the purposes of licence Condition B should include amounts payable in relation to diversions other than those required by section 185 of the Water Industry Act 1991.

Ofwat is therefore asking Yorkshire Water to indicate whether it would be prepared to agree to this licence change and whether we have any views on the proposed definition text below for inclusion in a revised Condition B:

‘In relation to the period from 1 April 2020 to 31 March 2025, amounts payable in relation to the alteration or removal of any relevant pipe (as defined in section 158 of the Water Industry Act 1991) or other apparatus that the Appointee is required to carry out under the New Roads and Streets Works Act 1991 or any other statutory provision except section 185 of the Water Industry Act 1991.’

Ofwat has also asked companies to complete a data request that includes a table for the provision of diversion expenditure and revenue information from 2011-12 to 2024-25, as updated by Ofwat on 20 August 2019.

5.1. Our feedback

We note Ofwat’s proposals to address the issue of substantial increases in non-section 185 diversions expenditure forecast across a number of companies driven by expected large infrastructure projects, such as HS2. We have included such forecast costs in our PR19 business plan submission. We also recognise that such expenditures can be uncertain given the nature of the projects.

We agree with Ofwat that the simple retention of all diversions income within the price control but excluded from net totex and cost sharing will leave companies with the full risk of bearing differences between forecast and actual costs of all diversions. We would support adaption of this approach to include all diversion costs within the totex calculation for the AMP7 period. Should diversion costs be lower than forecast, customers would gain some benefit depending on the applicable cost sharing rate.

We also believe under Option 2, where costs and revenues are outside the price control, to be workable. Companies would be effectively incentivised to be efficient in order to keep the differential between costs and the amounts companies can recover as low as possible.

In relation to Option 2, we have reviewed the proposed amendment to the definition of “Excluded Charges” under Paragraph 2 of Condition B (“the condition”). It is our understanding that this proposed wording would be inserted as an additional defined term within the condition and the remainder of the definitions currently within the condition would remain as currently drafted. On this explicit understanding, we can confirm we do not have any objection to the following wording, as proposed, being added to the condition. We reserve our position on this amendment to the condition should our understanding as explained above, be incorrect and would ask that we receive written confirmation if this is the case.

6. Summary

We welcome Ofwat re-examining its approach to regulating developer services within its PR19 Methodology and have considered its new proposals. We note that Ofwat intend to apply the proposed changes to all companies in their Final Determinations.

We have provided feedback above covering the four key areas:

- the developer services end-of-period reconciliation (section 2).
- incentivising accurate developer services forecasts (section 3).
- the treatment of developer services in the revenue control (section 4).
- the treatment of diversions (section 5).

In summary the feedback is as follows:

- the developer services end-of-period reconciliation (section 2).
  - given the dynamic nature of the new connections market envisaged in the years ahead, we would welcome discussion with Ofwat ahead of the Final Determinations about how the calculation of the DSRA and the unit rates could be further improved through the inclusion of more up to date company forecasts reported annually during the 2020-25 period.
  - we consider that the application at PR24 of reconciliation adjustments to the RCV would allow impacts on future customers to be smoothed over a longer period.
- incentivising accurate developer services forecasts (section 3).
  - we do not support the proposed inclusion of developer services into the RFI mechanism.
  - we believe improvements can be made to a standalone developer services specific incentive that suitably accounts for the potential variability of activity in this market.

  - we would like to discuss with Ofwat ahead of the Final Determination how using the RFI approach for incentivising forecasting accuracy for developer services revenues will operate in practice and ensure current and future customers are not exposed.

- the treatment of developer services in the revenue control (section 4).
  - we are broadly supportive of Ofwat's proposed approach to ensure consistency in calculating net totex for fast track, slow track and significant scrutiny companies.

- the treatment of diversions (section 5).
  - we note Ofwat's proposals to set non-section 185 diversions income outside the of the price control due the unpredictability of the costs and associated revenues, and the related risk this leaves companies to bear.
  - we have provided our feedback on Ofwat's draft definition text to be incorporated into 'Excluded Charges' for the purposes of Condition B.

Ahead of the Final Determinations we would welcome the opportunity to assist Ofwat in developing its proposals.

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