

CONSULTATION RESPONSE



DEFRA's review of OFWAT – a call for evidence

29 Oct 2010

Introduction

1. The HBF welcomes the opportunity to respond to the above-mentioned 'Call for Evidence'. As the main trade federation for the House Building Industry in England and Wales we have over 300 Members who build approximately 80% of all new homes in the UK. From the HBF's perspective, a Review of the Water and Sewerage Industry's Regulator cannot come at a better time in relation to the challenges that our Members face in dealing with the Companies who operate in these Sectors and the way in which they are regulated.

Setting the Scene

2. In providing our comments on the planned review of Ofwat, we firmly believe that it is of fundamental importance to first set the 'scene' in terms of the business environment in which our Members are expected to operate, insofar as it relates to water supply and sewerage infrastructure. A key aspect of this 'scene setting' is the relationship that exists between our Members and respective Companies. Since the privatisation of the Water and Sewerage Sector in 1989, our Industry has on average built in the region of 110,000 new homes per year, with peaks of around 165,000 new homes occurring in the mid 2000's. That said the present economic climate has seen a considerable dip in new home completions but all stakeholders, including most Companies, are acutely aware of the need to build some two million new homes by 2020. In comparison with the existing housing stock (about 22 million homes), our Industry's impact in terms of increasing the housing stock is around 1%. In addition we contribute in excess of 2.5% to total UK GDP.

3. It is therefore disappointing to report that there is a far from harmonious and at times difficult relationship between our two Industries. There are possibly many reasons for this disharmony but namely, Companies see new housing as an unwelcome intrusion into their core business as a regulated industry. Moreover, house-building is considered to be almost incidental to their overall business objectives.

4. Conversely, without house-building most Companies have little in the way of meeting two of their main business objectives, namely, to increase their asset base, which in turn provides extra revenue streams. Despite these intrinsic benefits, we are seen more as an imposition by a considerable number of Companies. Moreover, with a dependency on

what are in effect private monopoly enterprises, we are often viewed as easy pickings for unfair and manifestly inequitable charging regimes. Add to this the underlying levels of poor service and our role as an important customer is rarely realised and/or accepted. Indeed, in certain Companies there is a prevailing mindset that house builders get away with not contributing enough to the impact that new housing has on the existing water and sewerage networks – this is anathema to the Companies legal obligations pursuant to a duty under Section 94 of the WIA 1991 in terms of ‘effectually’ draining their area. Furthermore, it causes our Industry many problems when progressing developments in some Companies areas.

5. This can no better be displayed than in paragraph 47 of the Supreme Court Decision between Barratt Homes v Welsh Water judgment of 9th December 2009. The whole aspect of this case goes a long way in placing into some context the relationship between house builders and many of the Companies. The fact that house builders are required to work within the existing legislative framework where we gift assets to Companies who gain a financial benefit in perpetuity is one which is seldom recognised. Moreover, no compelling case has ever been presented by Companies that the maintenance of these ‘gifted’ assets represents a financial burden to them yet they raise this as a major issue without any factual evidence to support such a claim.

6. In terms of providing a commercial perspective if we take Ofwat’s current statement of average water supply and sewerage charges across England and Wales (£343/dwelling) and an annual new home completion rate of 150,000 dwellings, the following facts emerge:-

- New revenue from water and sewerage rates - £51.45 Million/annum
- New Revenue from infrastructure charges - £90.0 Million/annum

Over a ten year period, this will generate close to £1.50 billion in new income to Companies with virtually no risks attached.

7. Without wanting to labour this point any further we find ourselves between ‘a rock and a hard place’ by having to work with an Industry in which we are seen neither as a customer or a consumer but more as a “necessary evil”. Moreover, we are often trying to secure fair and equitable justice from a Regulator more committed to other causes. This is far from satisfactory., especially where Companies have little to no understanding, outside of their regulator responsibilities in terms of how new development interacts with say, the Building Regulations, together with a raft of controlling environmental legislation. More importantly, scant regard is given to the benefits new build brings when responding to Climate Change and in taking forward the need for Sustainable Developments. In fact many Companies are in denial that new homes are capable of reducing water usage.

8. We feel that this section of our response in terms of “setting the scene” is fundamentally important in being able to provide a frank but realistic view of Companies and their prevailing attitudes. As for Ofwat they have the unenviable task of having to regulate in this far from satisfactory environment. This is made even more difficult when some Companies openly challenge Ofwat’s position on fundamental issues, a point we will expand upon further in this document. As an observation it would be true to say that many Companies appear to have succumbed to a “Bankers Blind Spot” to the many issues relative to house building. Moreover, they have become adept in applying their own interpretation of Legislation and Industry Guidance. Many examples of this exist throughout our day to day involvement with Companies - this is an aspect that we will return to later in our response.

9. In the Call for Evidence we note that there are five focused areas where comments have been requested. These in turn form the framework to our response. Moreover, we would also wish to state that in many instances it is the case that specific issues stated in a generic context are sometimes embedded in the need to drill down into the detail. In not wanting to cloud any issue with a convoluted explanation of such detail, we see no reason why this should not be expanded upon at a later date, especially if we are to be given the opportunity to give verbal evidence.

Statutory Framework and Decision Making

10. From the house-building perspective the statutory framework controlling water and sewerage infrastructure matters emanates from extant legislation, augmented with industry guidance from Ofwat. In relation to these two areas, house-builders are often sandwiched between Companies who apply their own spin and interpretation to legislation and the guidance/direction from Ofwat, who often seem somewhat reluctant to challenge or take forward issues in a proactive way. From the outside looking in, at times it seems as if the “tail is wagging the dog”. There are no two better examples of this than the way Infrastructure Charges¹ are applied, or what at present looks like a monumental mess in the way that Commuted Sums and Asset Payments are calculated when a Water Main is requisitioned under the WIA 1991. The variation in charging methodology and the approach taken by any number of Companies just in these two areas is difficult to accept. We even have the absurd situation where some Companies openly state that they are not prepared to accept Ofwat Guidance because, in their eyes, it is not seen as a statutory requirement to adhere to it. Other examples also exist where such inconsistencies are prevalent in the areas of sewerage and water network reinforcement. All of which culminates in many HBF members taking a

¹ Infrastructure Charges are levied as required under Section 146 of the Water Industry Act

commercial decision of not challenging costs because of the need to progress a site, this can be construed as being a far from satisfactory situation.

11. The only other route of challenge to any issue is through a Determination to Ofwat. However this comes at a risk and with a protracted time period in getting the issue resolved because of the length of time it takes for Ofwat to determine an issue. Indeed, based on the reported experience of HBF members' periods far in excess of the 16 weeks quoted by Ofwat for a determination are rarely met. Reality is that determinations take the best part of a year or more. We would therefore conclude that there needs to be some serious consideration to these stated levels of service for determinations. That said this process does seem to be made worse by the attitude of those Companies who constantly miss deadlines for responses and seek extensions of time as a matter of course.

12. As we have previously stated the water supply and sewerage sector lacks any recognition of house-builders being a customer. Moreover, as an economic regulator, there is no compulsion on Ofwat to adopt or recognise our industry as a customer. This highlights a major problem with this sector in that it is too regulatory driven rather than customer focused - it is even less developer focused. With Ofwat being accountable to Parliament and not a specific person it is difficult to see a constructive pathway for meaningful debate to instigate change or referral of issues to an organisation who can assess Ofwat's decision or performance.

13. As an action from this review of Ofwat we would also like to see a change in the status of their Industry Guidance. Considerable progress could be made in making Ofwat Industry Guidance statutory and binding in that Companies must comply or suffer some form of penalty and even be investigated under a breach of a specific Licence Condition.

Sustainable Development

14. Sustainability is now part of our Industry's daily diet. More importantly, we are at the forefront of providing new homes which are metered, have low water usage and subsequent lower sewage discharge loadings. As we progress towards Zero Carbon by 2016, water usage and corresponding discharges will reduce still further. In light of this we have no evidence which we can submit that supports the objective for Sustainable Development being recognised by Companies and/or Ofwat. Indeed, despite Part G of the Building Regulations imposing a maximum water usage of 125 litres/person/day (as of 1st April 2010), we can find no WaSC having factored this reduction into their water demand calculations for new developments and/or revised discharge design criteria for foul sewers. In reality, the

converse applies in that these reductions by the house building Industry are being used as a convenient means of creating spare capacity in existing drainage networks and from a water supply perspective, a useful means of off-setting potable water losses through unaddressed leakage.

15. In many respects when one refers to the guidance and policies that are governed by Ofwat our industry is being penalised for being sustainable. - all of which is to the financial benefit of Companies. It could even be argued that the existing legislation, which has its roots in pre-privatisation criteria, is not reflective of house builders gifting of sustainable assets to Companies which require little to no maintenance or is mindful of the way things have moved on in relation to Climate change adaptation.

16. A good example of this is the Companies 25 year Long Term Strategic Direction Statements which were produced a few years ago. All of these Statements rightly cited issues surrounding the impact of development although some were more optimistic in relation to where we are today in relation to housing numbers. However not one of these Statements talked about the Code for Sustainable Homes and the way house builders through metering and low water usage appliances are helping the Water and Sewerage Sector be more sustainable. Is this an oversight or an acceptance that the Companies and possibly even Ofwat have their heads buried in the regulatory sand?

Relations with Other Regulators and Water and Sewerage Companies

17. It would be true to say that other Regulators have a more business like and proactive approach in dealing with the HBF and more importantly the need to promote competition. The way that competition takes place in the water supply and sewerage sector, when considering new developments is at times farcical but in reality, it is deeply concerning. Many issues are immersed in 'smoke and mirrors' with an element of not wanting competition in "my backyard" as it will affect my regulatory business.

18. There is however a defined North-South divide in the way Companies have embraced competition and sadly, Ofwat have been somewhat impotent in being able to influence many Companies to progress competition. This is also compounded by the house builders' lack of confidence or trust in the procedures and mechanics of the process, especially when it comes to Inset Appointments and/or New Appointments and Variations (NAV's). In the main we believe that this is due to the Companies and Ofwat's need to adhere to statutory procedures with an element of due diligence. We fully understand the process and limitations but we are yet to be convinced that Ofwat are looking at this with practical solutions to compliment the development process.

19. At this juncture it is worth noting the superlative work Ofgem have recently done in promoting competition and the issuing of 'Guaranteed Standards of Performance'. Here is a classic example of where a regulator was being "wagged by the tail" but took an assertive stance and turned things around. We would suggest that Ofwat needs to take a leaf out of Ofgem's book and produce a series of actions, with binding statutory commitments and which would benefit UK house-builders. If anything, such an approach has the propensity to at least get Companies to adhere to existing Legislation and Guidance. In looking in from the outside there does at times seem to be an element of fear in relation to Ofwat wanting to progress issues with Companies. However there appears to be a certain comfort by Ofwat in letting the Companies take the lead and then waiting to see if issues are challenged by the Determination process.

Protecting, Serving and Representing Customers

20. In relation to our previous comments it must now be evident that many issues exist arising from our relationship and dependency on Companies and indeed, Ofwat. It is not as if we have not highlighted this to the previous Government and discussed matters in depth with Defra and CLG. Unfortunately, our experience is one whereby both of the government departments cited are either oblivious to the issues raised or have no wish to go into the detail of any specific area. We would even observe that this "Bankers Blind Spot" is a serious concern for our Industry in relation to the Standards emanating from the Flood and Water Management Act for SUDS and the Mandatory Build Standards for adoptable sewers. Political expedience seems to be overriding sound logic, commonsense and practical considerations.

21. Whether it is Ofwat or CCWater, it is true to say that house-builders are rarely embraced as a key customer and hardly ever listened to. We look to this review to redress this imbalance.

Value for Money

22. In relation to Ofwat's approach in comparison to other Regulators in England and Wales we have previously stated that Ofgem have adopted a more pro-development approach in the last few years. We look to the outcome of this review of Ofwat to create something very similar.

23. With regard to value for money, it is universally accepted that for the Customer the privatisation of water and sewage has possibly brought benefits. However it is impossible to

evaluate at what cost and whether better value could have been achieved, but it is interesting to observe the substantial increase in the pre-tax profits of the Companies during 2009-10. In a time of austerity for many other Sectors they do seem to be bucking the trend.

24. For house-building and in the context of the contributions we have made, it is evident that the whole process suffers from a lack of transparency, especially when it comes to the expenditure side of the equation. It is somewhat difficult to accept that in gifting new assets to Companies, which are set on a 12 year asset calculation, we are disproportionately contributing to the Companies revenue (and long term profits) as these assets have a far greater life span than what is being allowed in the legislation with low maintenance costs. The complete lack of transparency of costs provides a compelling argument that our Industry is in fact getting a really bad deal out of the Water and Sewerage Sector(s). Again we look to this review to redress the imbalance.

25. To conclude on this section and to expand on what may be regarded as a regulated anomaly we would draw attention to the 'Financial Performance and Expenditure of the Water Companies in England and Wales 2009-10' and page 38:-

5. Accounting separation

Each appointed water company is a vertical monopoly in its area, and controls the:

- Supply and treatment of water and sewerage;
- Network of water supply pipes and sewers; and
- Sale of water and sewerage service to customers.

The costs and revenue associated with these are currently accounted for and regulated together. This means that it is difficult to get accurate information about the costs involved for each stage of the delivery of water and sewerage services.

26. We would see this as a frank but startling admission by Ofwat and provides little comfort in the fact that house-builder contributions may not have been used for the purpose they were legally designated for. It also poses more questions than answers in that the economic regulator is not able to ascertain the detail of costs. This we would see as being totally unacceptable in relation to new development and would draw us to the assumption that we are in fact subsidizing many aspects of existing network improvements which are not

as the effect of the increase in new properties. The way Ofwat looks at macro economic rather than micro costs associated with new build is a serious flaw in the current regulatory framework.

Conclusion

27. The HBF welcomes the opportunity to provide written evidence on this Review of Ofwat and as can be seen from the content/issues raised in our response there are some substantive matters which have been highlighted. The imbalance that exists both in levels of service and charging policy with Companies has for many years been a major concern to our Industry, coupled with at times what looks like the ineffectual way the Companies are regulated for new development is an ever growing issue for house builders. From our perspective, costs, cash flow and margins are being seriously affected in this present economic climate yet Companies seem to be flourishing. We would openly admit that to address this imbalance would not necessarily save house builders substantial sums of monies but it would go a long way in tipping the scales back to address what is an unfairly apportioned costing policy applied by Companies. All we ask is fairness and equity to prevail – this review has the means to deal with an imbalance that has persisted for many years.

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