

Board Assurance Statement

Charging arrangements for new
connection services 2022/2023

Board Assurance Statement

As Directors of South East Water we recognise that it is our responsibility to provide strategic leadership and to promote good corporate governance within a framework of effective controls, enabling compliance with our obligations and the management of risks.

In this statement we describe the systems of internal control we relied on to ensure that we comply with our statutory, regulatory and licence obligations relating to our charges for new connection services and in particular that our charges for new connection services and our charging arrangements for 2022/2023 comply with the charging rules for new connection services issued by Ofwat including those relating to infrastructure charges. We have included in this statement relevant information on assurance relating to the infrastructure charges which was carried out together with the assurance of other new connection charges.

We have also paid particular attention to the issues related to the transition to new methods of charging which started in 2018 in the context of legislative changes and to maintaining the balance of charges between developers and other customers. We have considered the interplay between the requisition charges and the revised income offset payment since 2020.

In setting our charges for new connection services we followed the principle that they should reflect fairness and affordability, environmental protection, stability and predictability, transparency and customer-focused service, and costs of the relevant service. We also ensured that no undue preference is shown to, and that there is no undue discrimination against, any class of customers or potential customers.

Governance and Board oversight

Board oversight

We have established a strong governance and management framework ensuring statutory requirements are met and that the data we publish is robust and of a high quality.

A specific governance and assurance process was put in place by the Board for the preparation of our charges supplementing the well-established systems of internal control already in place followed for all regulatory submissions and customer focused publications.

This process incorporated oversight by the Board and a review and approval by Senior Management and the Executive Directors.

The Board finally reviewed and finally approved the infrastructure charges together with the other charges for new connection services on 02 December 2021 having considered the external assurance relating to these charges.

In respect of new connection charges and infrastructure charges the Board considered the methodology for setting out charges for new connection services for 2022/23, the application of the income offset to the infrastructure charges and the requirement to include a statement of significant changes where charges for typical developments would increase by more than 10%. It also prescribed that charges and relevant documents should take due account of the consultation with the Consumer Council for Water.

The Chair of the audit and risk committee and the Executive Directors were jointly authorised to finalise the new connection charges for 2022/23 and the charging arrangements for new connection services for publication and to finalise, sign, publish and submit to Ofwat the Board assurance statements relating to charges for new connection services and infrastructure charges on behalf of the Board in accordance with the relevant charging rules.

Internal control processes

We have relied on comprehensive and transparent controls and assurance mechanisms which set out clear accountability for setting our charges. The data and assumptions used and our charging model have been thoroughly reviewed internally and externally.

Maintaining the balance of charges between developers and other customers

The process we followed to ensure that the balance of charges between developers and other customers is broadly maintained was similar to the process followed last year.

The models and methodology that were developed in 2017/18 to monitor the balance of charges were used again this year with updated data collected during the first years implementing our new charges for new connection services and infrastructure charges in order to maintain a consistent approach to the assessment of the balance of charges.

This model had been externally assured last year by Frontier Economics who had reviewed our methodology and assumptions and concluded that we had taken the necessary steps to ensure the balance of charges was broadly maintained.

This year's review of the balance of charges was carried out against an update of the baseline which had been determined in 2018 following a systematic review of developer related expenditure and of the company's expenditure, of contributions relating to requisitions (including on-site and off-site), asset payments, connections and infrastructure charges over a five year period. To meet the requirements of our regulator's price determination, we are also including relevant costs of our zonal strategy (i.e. investment in our network necessary to respond to additional demand) in the calculation of infrastructure charges. Including zonal schemes' costs in the calculation of our infrastructure charges would have significantly increased the levels of contribution recovered from developers. The percentage of income offset that is applied against infrastructure charges has therefore been set at a level that ensures that the percentage of contribution by developers is broadly maintained and that therefore the overall balance of charges between developers and other customers is broadly maintained.

The assurance of our methodology for calculating the income offset has also been carried out to ensure the balance of charges is maintained with the offset moving from onsite mains to infrastructure charges since April 2020.

We ran our models over a number of scenarios and used updated assumptions on the forecasted levels of development that were consistent with the levels of development recorded over the past 5 years and that underpinned the current charging balance in order to forecast contributions and expenditure levels moving forward.

We have tested the broad balance of charges for both the larger and smaller developers by running the new charges alongside our previous requisition and connection charges. We did this across a number of schemes for different sizes and types of development. By carrying out this comparison between the methods of charging we ascertained that the new method of charging broadly maintained the balance between developers and other customers.

Infrastructure charges

When setting our infrastructure charges we ensured that they were in accordance with the principle that the amount of infrastructure charges will over a period of five consecutive charging years cover the costs of network reinforcement that we reasonably incur.

For the calculation of the infrastructure charges for 2022/23 we have considered the period to 31 March 2027.

The infrastructure charges for 2022/23 were based on the models designed for the implementation of the new method of charging from April 2018 and were updated

using relevant data collected in the first years of operating the new method of charging and revised assumptions. Internal assurance was provided by data owners for the key inputs to the models.

When determining reinforcement costs used for calculating infrastructure charges, we considered in particular that only relevant costs relating to reinforcement required as a result of new connections and new development sites should be included. Costs relating to zonal schemes have also been included in reinforcement costs used for calculating our infrastructure charge since 2021/2022 to the extent they related to new developments. We have taken a similar approach to the above, first apportioning the cost of the schemes relating to new developments and then, in respect of those schemes, apportioning the costs relating to new connection requirements in 2022/23.

After reviewing new connection numbers for last year, and year to date, we have decided not to adjust our original new connections forecast and therefore have used this to calculate our charges.

Income offset

From April 2020 the way we apply the income offset has changed. Previously we applied the income offset to the requisition charge; from April 2020 the income offset has been applied against the infrastructure charge.

We have calculated our income offset per connection for 2022/23 using the average percentage of income offset we applied over the last five years. During that period, the income offset was calculated using both the methodology that was applied before 1 April 2018 (where the cost of any network reinforcement was included in the total cost of the scheme to which the income offset was applied) and the methodology that has been applied since 1 April 2018 (where the cost of any network reinforcement was not included in the total cost of the scheme to which the income offset was applied).

In order to determine the average percentage of income offset that best ensured we could maintain the balance of charges between developers and other customers, and after considering different methods of calculating it over the relevant period, the percentage of income offset in respect of pre-April 2018 development was calculated as a proportion of the costs of the site specific works (rather than the total costs inclusive of any network reinforcement). Having normalised the data between the pre-April 2018 schemes and the post-April 2018 schemes, we calculated the average percentage of income offset over the relevant five year period.

We have then applied this average percentage to our forecasted total cost of onsite mains in 2022/23 and divided the result by the forecasted number of new connections in 2022/23 to obtain an income offset per plot. We are aware that the income offset is an important tool in maintaining the balance of charges. The inclusion of zonal

schemes in the calculation of our infrastructure charges impacts the current balance, and in line with the charging rules we have adjusted our income offset to broadly maintain the balance of charges. This method has been externally reviewed.

External assurance and engagement

In addition to the internal assurance undertaken, the Board has also obtained assurance from Frontier Economics in respect of our charging methodology.

We also provided the Consumer Council for Water with information on the revisions to our infrastructure charges and other new connection charges with a copy of our draft methodology for infrastructure charges and other new connection charges. We met with CCW to discuss our processes and the methodology applied to broadly maintain the balance of charges between customer and developer. CCW did not raise any issue with our proposals.

Frontier Economics was commissioned to review our infrastructure charges and new connections charges to comment on the extent to which our approach satisfies the guidance set out by Ofwat and Defra.

They produced a detailed assurance statement, which concluded:

We have reviewed SEW's approach to setting developer charges for 2022/23, and ultimately we find that its approach is in line with Ofwat's guidance. Also, based on our understanding of the economic principles that underpin competition law we believe that SEW is unlikely to be exposed to a material risk of a competition complaint.

As described in more detail in the rest of this note, Ofwat's charging rules have remained largely unchanged compared to last year. At a high level, SEW must ensure that its charges are cost reflective – albeit Ofwat has clarified some of its rules, resulting in relatively small changes to SEW's approach. In our review of SEW's approach, we believe the most noteworthy points are as follows:

- **New contractor rates:** *SEW has recently agreed new terms with its subcontractor. This has resulted in an increase in rates of around 8% compared to last year, which is driven by an increase in labour, materials, and traffic management costs. SEW has demonstrated that it followed a robust procurement process and that the resulting rates are competitive. In addition, SEW has notes that it will also carry out ex post checks on its subcontractor rates on a sample of projects to ensure that its charges are broadly cost reflective. We believe this is reasonable, and we would expect that the increase in costs will have affected most companies in the sector too.*
- **The 5 year rule:** *Ofwat has clarified its charging rules on how to set the infrastructure charge. Previously, there was some confusion in the sector around how to interpret the '5 year rule' – i.e. that the charge should be cost reflective over a 5 year period. Some companies interpreted the rule as meaning that the charge should be cost reflective over the course of the AMP (i.e. including some backward looking data and forward looking data), or on a rolling average basis spanning across AMPs (including some backward looking data and forward looking data), or on wholly forward looking basis. Ofwat has*

clarified that the charge should be cost reflective on a wholly forward looking basis. For 2022/23 charges, this means the charge must be cost reflective over the period 2022/23-2026/27. SEW has updated its approach accordingly.

- **The balance of charges:** Similar to last year, companies should use the income offset as a balancing item to ensure that the balance of charges between developers and other customers is broadly maintained at the level prior to the April 2018 rule change. SEW's approach is as follows:

- SEW has reviewed historical data to estimate what the income offset represented as a percentage of the total cost of developer services prior to April 2018.
- It has forecast the total cost of developer services for 2022/23 and then applied this historical percentage to estimate the income offset.

This methodology ensures that the percentage is the same and therefore the balance of charges is maintained. We believe this approach is reasonable.

- **Intra zonal schemes:** As part of the PR19 final determination, Ofwat allowed extra funding for SEW's "intra-zonal" schemes but determined that 75% of the cost should be recovered from developers during AMP7 instead of through customer bills. We understand that SEW has since engaged with Ofwat and provided additional evidence to demonstrate that developers should contribute less than 75% of the cost, and also that this cost should be recovered over a longer period of time, rather than over 5 years. This results in a lower increase in developer charges relative to that implied under Ofwat's approach. We believe SEW's approach is reasonable, and we recommend that it continues to engage with Ofwat to ensure that the approach is agreed, in order to avoid any cost recovery issues.

Board Statement

For the preparation of this statement we have considered compliance with our statutory, regulatory and licence obligations relating to setting our charges for new connections and the requirements of the charging rules for new connection services including those relating to infrastructure charges.

Our governance and oversight processes have not identified any material deviation from or non-compliance with these obligations and to the best of the Board's knowledge after reasonable enquiries the company has complied in all material respects with these obligations and the company is taking appropriate steps to ensure compliance and manage and/or mitigate the relevant risks.

This enables us to have a high degree of confidence in the information presented in this statement and in our charges for new connection services and in our charging arrangements for 2022/23.

Based on the scope and outcome of the process review detailed in this statement the Board is able to confirm that:

- i The company complies with its obligations relating to the charging rules for new connection services;

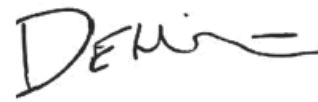
- ii The company has appropriate systems and processes in place to make sure that the information contained in the charging arrangements and the additional information relating to our charges for new connection services is accurate.

We have provided in the previous sections of this statement explanations on how the company has ensured that the balance of charges between developers and other customers is broadly maintained.

Signed on behalf of the Board by:



Chris Girling Chair of the Audit and Risk Committee



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