

Board Assurance Statement

Charging arrangements for new
connection services 2021/2022

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 2021/2022 comply with the charging rules for new connection services issued by Ofwat. In making this statement we had also regard to the charges scheme rules as they apply to infrastructure charges for 2021/2022 and 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 new approach to requisition charges and the revised income offset payment.

In setting our charges for new connection services we followed the principle that they should reflect fairness and affordability, environmental protection, stability and predictability and transparency and customer-focused 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 3 December 2020 having considered the external assurance relating to these charges.

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 started 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 this year 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. In order to rebalance the charges and ensure that the percentage of contribution by developers is broadly maintained, we have increased the percentage of income offset that is applied against infrastructure charges.

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.

We ran our models with our new charging methodology 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, less any other amounts we may receive for network reinforcement.

For the calculation of the infrastructure charges for 2020/2021 we have considered the period to 31 March 2024.

The infrastructure charges for 2021/22 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 year 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 were also included in reinforcement costs used for calculating our infrastructure charge for 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 2021/22.

For the calculation of infrastructure charges for 2021/22, we took account of the level of activity experienced in 2020. This did not result in any significant change

compared to 2020/21, as the total numbers of new connections carried out was almost back to pre Covid-19 levels at the end of 2020.

The actual impact of Covid-19 on new connection activities during 2021/22 is unknown. However, we will be able to adjust the 2022/23 infrastructure charges to take account of any shortfall or over-recovery of infrastructure charges in 2021/22 when determining the five year rolling average next year.

Income offset

From April 2020 the way we apply the income offset 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 2021/22 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 2028 (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 2028 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 2021/22 and divided the result by the forecasted number of new connections in 2021/22 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.

In order to mitigate the potential disproportionate impact on certain types of developments of applying the income offset to infrastructure charges, we will also be capping the income offset to within 10% of what the income offset would have been using the offsetting method that applied until 1 April 2020.

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. 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 draft developer charges for 2021/22. Ultimately, we believe that they reflect Ofwat's guidance, taking into account Ofwat's' charging rules, as well as some more recent guidance (e.g. in a recent consultation on on-site connection charges, Ofwat set out some concerns with connection charges across the industry, which SEW has reflected in this year's charges). We believe that SEW is also unlikely to be exposed to the risk of competition issues.

Relative to last year's charges, the main significant changes this year were:

- The balance of charges: Ofwat introduced new charging rules in 2018. While the rules changed, it also commented that companies should ensure that the 'balance of charges' between developers and end customers should remain broadly maintained relative to the position prior to the rule change. This requirement was ambiguous and companies approached the issue in different ways. Ofwat has since clarified its position and stated that the income offset should be used as a balancing item to ensure that the balance of charges is maintained. SEW has updated its approach accordingly.*
- Zonal strategies project: At PR19, SEW made a claim for additional funding for its 'zonal strategies' project, with the intention that the cost would be recovered through customer bills. In SEW's FD, Ofwat allowed the extra funding (albeit it applied an efficiency challenged) but determined that 75% of its view of the cost should be recovered from developers, with that cost being recovered during AMP7 – which in principle could have resulted in a material increase in charges for developers. SEW has produced evidence that developers should contribute less than 75% of the cost, and also that the cost should be recovered over multiple AMPs, which results in a lower reduction in developer charges relative to that implied under Ofwat's approach. We consider its approach to be reasonable.*

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, the requirements of the charging rules for new connection services and also those of the charges scheme rules relating to the 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 2021/22.

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

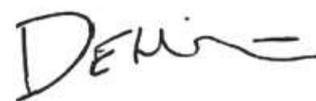
- i The company complies with its obligations relating to the charging rules for new connection services;
- ii The company has appropriate systems and processes in place to make sure that the information contained in the charging arrangements and the additional information relating to our charges for 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:

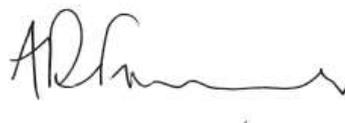


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