

05 July 2017

Trust in water

New connections charges for the future - England

www.ofwat.gov.uk

About this document

Water companies¹ have a duty to allow new connections to be made to their existing networks, including for new housing developments.

Water companies whose areas are wholly or mainly in England (“English water companies”) must implement our charging rules related to new connection services that have effect from 1 April 2018. For companies whose areas are wholly or mainly in Wales, we will consult and publish our rules, following the publication by the Welsh Government of final supplementary charging guidance to Ofwat on developer charges and other matters.

Our charging rules for English water companies will cover charges and asset payments by English water companies to developers, Self Lay Organisations (SLOs) and other customers for:

- connections with water mains and public sewers;
- the provision or adoption of new water mains, public sewers and lateral drains; and
- pipe diversions.

This document applies **only to English water companies** and does the following

- Consults on a proposed change to our charging rules from 2020 in relation to the treatment of the income offset and asset payments. We are publishing draft consolidated [Charging Rules for new connections](#) and [Charges Scheme Rules](#) alongside this document.
- Covers a number of issues relating to the implementation of our current rules that need to be applied from 1 April 2018, i.e.:
 - informs you of our expectations for how the sector can best implement these rules; and
 - informs you of a minor revision with respect to upfront publication of charges that we intend to make to our new connections charging rules services (unless directed not to by the Secretary of State);

¹ In this document we use the term “water companies” to refer to companies who hold appointments as water and/or sewerage undertakers under the Water Industry Act 1991.

- Consults on proposed modifications to licence condition C (Infrastructure Charges) of the appointments of English water companies.

This document should be read in conjunction with two earlier documents. In July 2016 we consulted on [a new approach to connections charging for English water companies](#) (“July 2016 document”). In December 2016 [we published our decision](#) to implement charging rules for new connections for companies (“December 2016 decision document”).

Responding to this consultation

We welcome your responses to this document by **5pm on 4 August 2017**.

You can email your response to charging@ofwat.gsi.gov.uk. You can also submit your response by post to:

Charging
Ofwat
21 Bloomsbury Street
London
WC1B 3HF

Information provided in response to this document, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1988 and the Environment Information Regulations 2004.

If you would like the information you have provided to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ with which public authorities must comply and which deals, among other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system or a blanket request for confidentiality will not, in itself, be regarded as binding on Ofwat.

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1. Introduction

Water companies have a duty to allow new connections to be made to their existing networks, including for new housing development.

Enabling a new connections charging framework that is clear and customer-focused is an important factor in ensuring trust and confidence in the sector. Getting charging right has a number of advantages to developers and end-customers. This can be achieved through a number of means.

- **More cost reflective charges send better signals to enable and encourage efficiency.** For example, the cost of network expansion can be reduced through sending cost-reflective price signals.
- **Protecting the environment.** For example, charges provide an opportunity to improve the delivery of social benefits such as environmental protection, where charges reflect the value of the environment and potential impacts on it.
- **Requiring transparency and predictability.** This shapes customers' experiences and helps build trust in the provision of services. It can also help manage costs and enable faster delivery of services because time is not lost in seeking clarifications on how charges are to be applied.
- **Helping affordability, fairness and acceptability.** Our rules can help ensure that a company's revenue (which is set through our price controls and recovered through customers' bills) comes from an appropriate group of customers.
- **Promoting effective competition for contestable services.** Clear, stable and cost-reflective tariffs can potentially facilitate efficient entry, especially when coupled with other measures.
- **Reduced administrative burden.** For example, in terms of a reduced number of disputes.

We have new powers, introduced by the Water Act 2014, allowing us to move from the current legislative charging framework to a more flexible charging framework. Our approach must have regard to [Charging guidance to Ofwat](#) and [Water industry: guidance to Ofwat for water and sewerage connections charges](#) ("Defra's charging guidance") in relation to English water companies that sets out four overarching objectives:

- Fairness and affordability;
- Environmental protection;
- Stability and predictability; and
- Transparency and customer-focused.

Some stakeholders had concerns with the previous arrangements – for example, that charges are too complex, unpredictable and unfair. Hence, after consultation, we published new charging rules in our [December 2016 decision document](#). These rules will come into force on 1 April 2018.

In the light of recent developments and the desire expressed in previous documents to address the issue of how to treat the income offset/asset payments, we want to ensure our rules remain up to date, fit for the future and are appropriately implemented.

We are publishing this document now, so that the sector can take account of the our proposals and expectations in a timely way with sufficient notice prior to the 1 April 2018 implementation date.

2. Proposed future changes to our rules

This chapter discusses a potential future change to our charging rules for new connections.

In our December 2016 decision document, we said that a different treatment of the income offset would help to ensure a level playing field for new connections services and improve transparency (the term ‘income offset’ refers to a reduction in a water company’s charge for the provision of a sewer or water main to reflect, in part, the income that an incumbent water company will receive from a new development). We also said we did not intend to require this change during this price review period (2015 to 2020), as we were concerned it could increase some end-customers’ bills. We said we would make any future change after considering the issue in more detail and further consultation with the industry. Therefore, this consultation document reconsiders whether we should change the way the income offset is treated.

Since we published our December 2016 decision document:

- there is evidence of growing support for making a change;
- some stakeholders have asked whether a change could be made sooner; and
- analysis undertaken as part of our review of the New Appointments and Variations (NAV²) market also confirmed that there may be benefits arising from this approach.³

We have now assessed this issue in more detail and we want to consult on our proposed changes. We have engaged further with some stakeholders who raised concerns (either through our previous consultations or March Review) with the current approach and asked incumbent water companies to send us data for our

² In this document we use the term “NAVs” to refer to small new entrant water companies that are not subject to full price controls. We recognise that NAVs can provide other services, such as their own wastewater treatment facilities or water resources. Our focus is on competition for new connections, so for simplicity we do not consider these other services further in this document.

³ In December 2016 we commissioned Frontier Economics to assist us in reviewing how the NAV market is working; to identify any features of the market that may be having the effect of creating barriers to effective competition; and to suggest options that Ofwat may want to consider to address any issues identified. In addition to an examination of relevant documentation, the review was also informed by extensive engagement with stakeholders. The review has now been completed and its findings are being considered by Ofwat. We are proposing to engage again with stakeholders on the findings of the review over the summer.

analysis, to better inform the development of our approach. We have used this as the basis for a consultation-stage impact assessment.

In the rest of this chapter, we first focus on water services, then we discuss wastewater services.

The issue

When a new development is built, there are two sets of water services provided to developers which are relevant to this consultation:

- **On-site work**⁴. This consists of the infrastructure needing to be laid out and connected to the incumbent water company's existing network. Many of these services are 'contestable'. Contestable services can be provided by a water company or others, such as the developers and SLOs. We understand that incumbent water companies generally have a significant share of on-site work for water, but a small share of wastewater services. If incumbent water companies do lay mains or a public sewer on-site, they can recover their costs through a 'requisition charge'.
- **Off-site work**. This covers incremental work needed off-site and on the incumbent water company's network due to new development. Only incumbent water companies (or its subcontractors) can undertake this work, so these are 'non-contestable' services. Incumbent water companies recover the costs of network reinforcement through an 'infrastructure charge'. This charge is paid if the water company, SLO or developer undertakes the on-site work. We understand that, generally, agreements between NAVs and incumbent water companies require the NAV to pass on the revenues it receives in infrastructure charges to the incumbent water company⁵.

To help level the playing field between incumbent water companies and SLOs, our rules also require water companies to pay SLOs an 'asset payment' of equivalent

⁴ In this document, we use the term 'on-site' means on or in the immediate vicinity of a development.

⁵ Relevant NAVs' licences ensure their infrastructure charges are no higher than the relevant incumbent's infrastructure charge. In practice, NAVs' infrastructure charges equal the relevant incumbent water company's infrastructure charge.

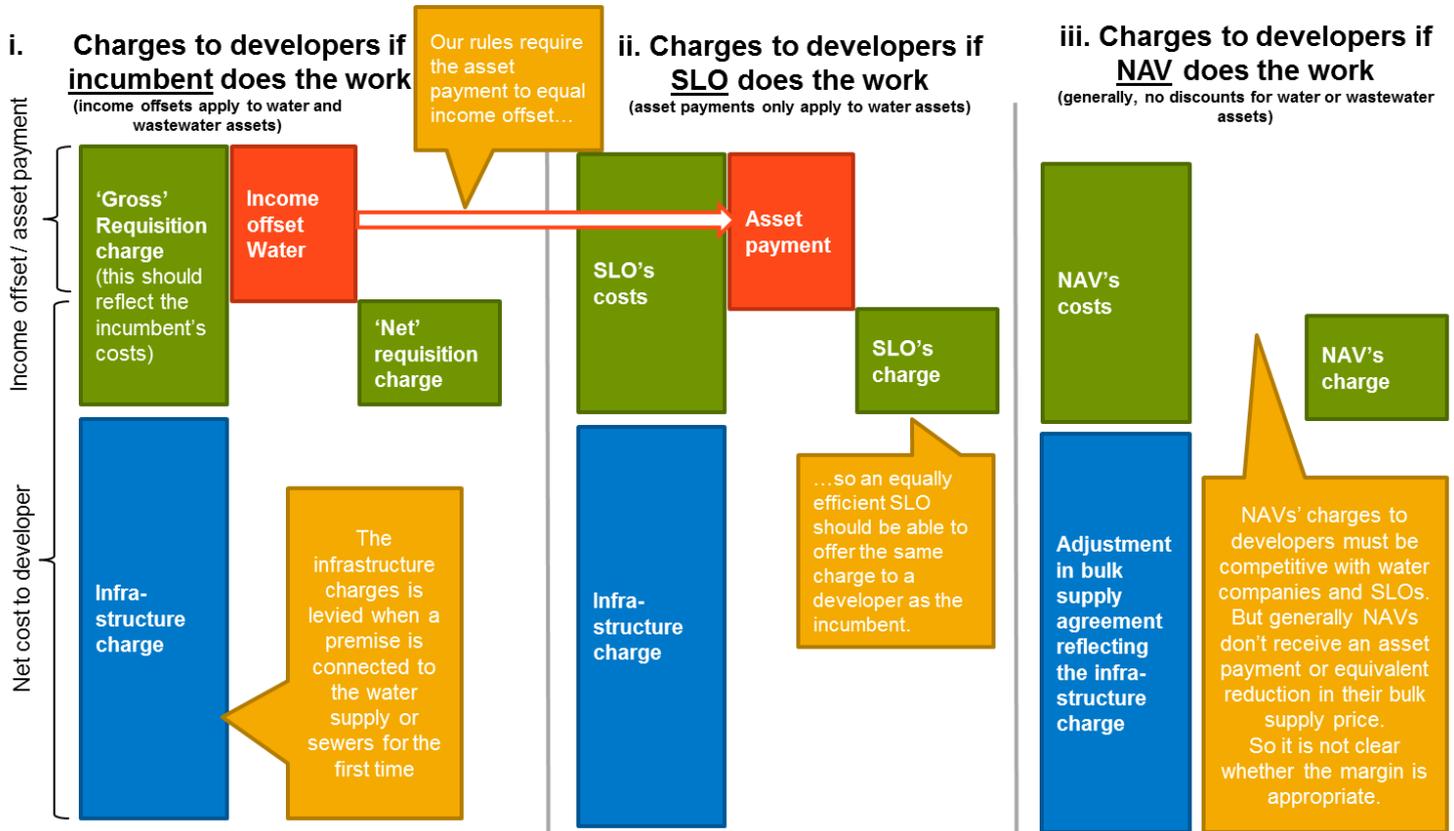
value to the income offset. ('Asset payments' are payable to developers and SLOs who build mains or public sewers that a water company adopts.) Critically though, incumbent water companies generally do not offer NAVs an equivalent discount. For example, they rarely, if ever, adjust their bulk supply price or any other part of their bulk supply agreement⁶ to account for the income offset or asset payment.

This creates the following concerns:

- **Distorting competition.** As shown in Figure 1, NAVs do not receive an income offset/asset payment discount. This puts NAVs at a disadvantage relative to incumbent water companies, developers and SLOs when competing for developers' services. This means NAVs may have to be more efficient or may have to cross-subsidise this activity in order to be competitive. Otherwise, they may not be able enter the market.

⁶ A supply of water from one water company to another is called a 'bulk supply'. The companies involved write a contract (a 'bulk supply agreement') setting out the terms and conditions for the bulk supply.

Figure 1: Payments and discounts if incumbents, SLOs or NAVs undertake the on-site work



Fair Water Connections (FWC) – an association supporting SLOs - has argued that SLOs are also disadvantaged relative to incumbent water companies, because:

- i) incumbent water companies may delay asset payments until they have done a post work review of the calculation; and
- ii) SLOs need information from an incumbent water company on the level of the income offset/asset payment before they can price their work, adding administrative cost and reducing service benefits.

Reduced competition harms developers and can hinder house building because competition is key to improving the cost, speed and ease of delivering on-site works. Reduced competition from NAVs could also lead to reduced choice, worse quality and higher prices to end-customers.

- **Fairness.** The income offset reflects the additional revenue incumbent water companies get from connecting new end-customers who will then be paying for water and wastewater services. But currently the income offset can only be paid when (and to the extent that) developments require on-site works, as it is

linked to the requisition charge. This means that those developments for which there is no requisition charge do not benefit from the income offset. This issue has been raised with us in discussions with Water UK and Thames Water.

We note that Defra's charging guidance asks us to make it, '**quicker, easier and cheaper for self and custom builders to connect to the water and sewerage networks.**' These developers may be less likely to need on-site work than larger developers.

- **Lack of transparency.** Currently, income offset/asset payments are not transparent. While a few incumbent water companies say they offer a discount to NAVs through their bulk supply agreements, this is not transparent and, according to the information we have recently received, most NAVs do not obtain a discount.

FWC has told us more transparency is needed over asset payments made to SLOs, as companies currently cannot always justify them when challenged.

This lack of transparency could increase distrust between SLOs and NAVs, and incumbent water companies. Lack of transparency could also distort competition to the extent that what SLOs and NAVs are competing on and against is not clear.

- **Efficiency.** The income offset often reduces the charges or costs of on-site works significantly, shielding developers from the full cost of the works. As noted above, the income offset can only be paid when (and to the extent that) developments require on-site works, as it is linked to the requisition charge. This means that price signals will be distorted, regardless of the precise approach incumbent water companies choose when formulating their income offset.

We recognise that requisition costs are likely to be a fraction of the total costs facing a developer. In some cases though, price distortions created by the income offset could lead developers to make inefficient decisions on the location of new developments. In turn, this can raise bills for existing customers, because changes in incumbent water companies' costs are shared roughly equally between the incumbent water company and their end-customers. This issue has been raised with us in discussions with Water UK and a water company.

Options to address the identified issues

Given the concerns with the current approach to the treatment of income offset/asset payments, we have considered alternative options. We:

- first briefly describe three alternative options to the status quo (Option 1) which we consider could address most, if not all, of the identified concerns;
- put forward what we consider to be a relevant assessment criteria; and
- provide a summary of our impact assessment for consultation.

We provide more detail on this impact assessment in Appendix A1.

We have considered the following options:

- **Option 1** – this is the status quo. We would not modify the charging rules we published in December 2016 that will come into force from 1 April 2018. Income offsets and asset payments would continue to be set against the requisition charge only;
- **Option 2a** - the income offset would be netted off the infrastructure charge instead of the requisition charge. Therefore, every new connection would receive an income offset. There would also no longer be a need for asset payments. The change would be implemented as of 1 April 2018;
- **Option 2b** - same as Option 2a, but it would be implemented later as of 1 April 2020; and
- **Option 3** - as under Option 2b, but for the period 2018-2020 incumbent water companies would include the income offset as part of any new bulk supply agreements NAVs would agree with incumbent water companies.

We have assessed Options 2a, 2b and 3 relative to the status quo against the following **assessment criteria**:

- **Competition** - does the option promote competition in the provision of on-site services? Would this lead to benefits for developers and end-customers?
- **Efficiency** - does the option provide clear signals that encourage efficient decisions by developers?
- **Consumer protection** - does the option have any unintended consequences?

- **Good regulation** - is the option proportionate and targeted? Does the option ensure transparency and predictability for all parties involved? Does the option raise implementation, on-going and/or unnecessary dispute costs?

Our assessment is mostly qualitative, other than for a few elements we considered we could quantify with sufficient certainty. The next section focuses on water services, while the issues raised by wastewater services are discussed separately.

Option Assessment

By setting the income offset against the infrastructure charge (and removing asset payments) by 1 April 2018, **Option 2a** achieves a number of benefits relative to the status quo. In particular, we consider that under this option incumbent water companies, SLOs and NAVs would be on a level playing field.

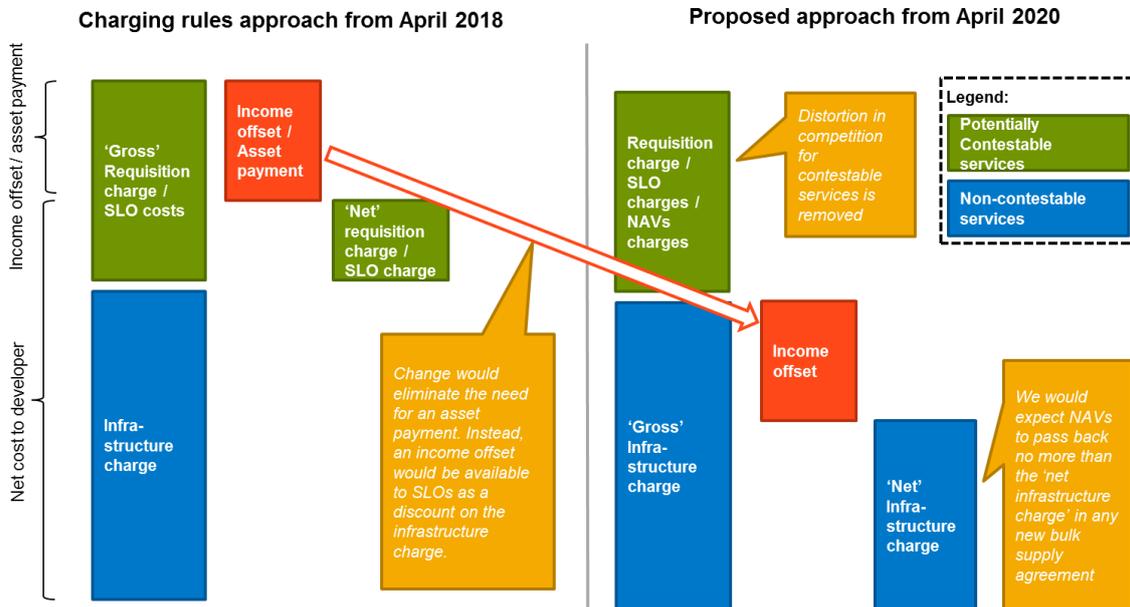
Under Option 2a we expect developers would pay:

- the incumbent water companies an infrastructure charge net of the income offset and the incumbent water companies' costs to undertake the on-site work;
- SLOs an infrastructure charge net of the income offset and the SLOs' costs to undertake the on-site work; and
- NAVs an infrastructure charge net of the income offset and the NAVs' costs to undertake the on-site work.

To protect developers and other customers, the precise level of the infrastructure charge would be calculated in such a way as to ensure the broad balance of charges between developers and end-customers does not change. This approach would be consistent with Defra's charging guidance and our existing charging rules.

Hence, all types of providers will be on a level playing field when they make offer to developers as illustrated by Figure 2. Today (and on 1 April 2018, if we did not modify our rules), the income offset/asset payments would be netted off against the requisition charge. This means that the competitive process may continue to be distorted. Under Option 2a the income offset will be paid to developers against the infrastructure charge and hence also when NAVs undertake the work (and asset payments would be replace by the income offset when SLOs undertake the work).

Figure 2: Overview of Option 2a (water)



Relative to the status quo, under Option 2a we expect more intense competition to lead to cheaper and better quality services for developers since all NAVs would no longer face a competitive disadvantage. This will lead to more choice and most likely cheaper prices and better quality services for developers. Furthermore, when NAVs obtain a new development they sometimes charge lower prices to end-customers. As a result the latter would also benefit under Option 2a. In addition, they could also benefit in terms of higher quality – i.e. more environmentally friendly services.

Option 2a would also deliver greater benefits than the status quo by providing better signals to developers to build in areas that are cheaper to connect. While this is a potential benefit, in practice it is unclear whether developers’ location decisions are significantly affected by the level of the requisition charge.

We also expect this option to be more targeted, proportionate, transparent and predictable than the status quo. As the infrastructure charge is paid for any new premise, developers will receive an income offset for each new premise, whereas currently they receive it only when the on-site infrastructure is requisitioned.

Lastly, Option 2a is expected to reduce the regulatory cost by increasing clarity and reducing the likelihood of disputes.

However, there are two disadvantages. First, in principle replacing the asset payments with an income offset of a similar amount to SLOs should have no impact. However, asset payments and income offsets are currently treated differently within

the price control. Therefore, as explained in Section 2.3 in Appendix 2.3 in detail, Option 2a may lead to some small and temporary increases in end-customers' bills, which may offset in part or in full any gains from increased competition, mentioned above. We have estimated this overall increase to be in the range of £0.6 to £10.4 million for two years, translating in an average annual bill increase of £0.02 to £0.19 per customer (see Appendix A1 for details). Second, Option 2a may also raise some short run one-off implementation costs, given that incumbent water companies would have limited time to implement changes before 1 April 2018.

Option 2b differs from Option 2a only in its implementation date for the suggested change in treatment of the income offset/asset payment. Postponing the implementation date from 1 April 2018 to 1 April 2020 (when our new price control takes effect) has two main effects relative to Option 2a:

- it does not raise concerns about temporary increases in end-customers' bills. This option would also reduce the short term implementation costs as incumbent water companies would have more time to implement changes; and
- the benefits in terms of competition, efficiency, good regulation and long term regulatory cost and burden would accrue two years later than under Option 2a.

In order to better assess the performance of Option 2b relative to Option 2a, we have undertaken some high-level quantitative analysis of the trade-off described above. We estimated that, in order for the benefits of early implementation via two more years of more intense competition in the provision of services to developers to offset the temporary two year increase in end-customers' bills, requisition and connection charges would have to decline by at least 0.4 to 4.3 percent (see Appendix A1 for details).

Option 3 would avoid the small and temporary increases in end-customers' bills that we expect under Option 2a, while at the same time avoid postponing the competition benefits to 1 April 2020. It would achieve this by introducing the formal change by 2020 as under Option 2b. In addition, it would also include a temporary measure to ensure that the competition benefits from early implementation are achieved from 1 April 2018. This consists of requiring incumbent water companies to provide income offset to NAVs as part of their new bulk supply agreements. We envisage this to only be in place only for 2018/19 and 2019/20. We consider this solution should be temporary because it is less transparent than extending the income offset to NAVs by netting it off the infrastructure charge. However, in this option the potential benefits from early implementation, other than competition, (i.e. more transparent charges) would be lost. Nonetheless, we expect this to be a small disadvantage.

Our provisional conclusion is that Options 2a, 2b and 3 are likely to perform better than the status quo. However, we provisionally consider **Option 3** is likely to perform better than any of the other options. Implementation of the income offset against the infrastructure charge from 1 April 2020 would avoid the temporary increases in end-customers' bills of Option 2a. Conversely, and unlike Option 2b, it would achieve an even playing field as early as 1 April 2018, though it would not achieve some of the other (smaller) benefits of Option 2a – i.e. benefits from early implementation in terms of increased transparency and clearer price signals. Therefore, we are keen to see the incumbent water companies provide to NAVs the same income offset discounts they provide to developers as part of their new bulk supply agreements from 1 April 2018 to 1 April 2020.

Wastewater

The situation is similar for wastewater, with the following differences:

- Incumbent water companies are not required to provide an asset payment;
- Adoption agreements do not require developers to pay for network reinforcement, although we are told that incumbent water companies often seek to have developers contribute to such costs to discharge planning conditions; and
- We understand that in practice, despite not receiving an asset payment if the assets are adopted, developers tend to undertake onsite work themselves; consequently, income offsets are rarely applied.

Given these considerations, we would expect that any income offset which companies apply against the wastewater infrastructure charge is likely to be small. Our charging rules currently give considerable flexibility to incumbent water companies in how they set their income offset, so we do not think that any significant changes are needed.

Given that the requirement to maintain the broad balance of charges between developers and end-customers does not apply to any one specific charge, but to the whole system of charges, incumbent water companies who provide wastewater services have the option of not introducing an income offset against the wastewater infrastructure charge. Instead they could adjust the income offset against the water infrastructure charge (or vice versa) if this was more practical.

3. Implementation of our charging rules from 1 April 2018

The sector's implementation

In September 2016, we informed the sector of our decision to postpone implementation to 1 April 2018, rather than 1 April 2017. This was to allow more time for incumbent water companies to consult with end-customers and respond to feedback before their charges are finalised. We said it would also give time for Water UK to explore the possibility of a more harmonised approach to implementation, which would reduce the risk of arbitrary differences in incumbent water companies' implementation, whilst still allowing companies to introduce innovative tariffs.

In December 2016 we published our decision to implement charging rules for new connections for water companies. Our decision covered the four overarching objectives set out in Defra's charging guidance to us:

- Fairness and affordability;
- Environmental protection;
- Stability and predictability; and
- Transparency and customer-focused.

In March this year, we undertook an informal consultation to gather views on the progress of the Water UK group and the industry's progress towards implementing the rules.

The key feedback we received at the end of April this year was as follows:

- Some stakeholders were worried that no incumbent water companies had yet provided any detailed information about the tariffs that they were considering. At the time, they had only been consulted on the high-level design characteristics.
- Some stakeholders were concerned that delays in the Water UK working group's progress could lead to incumbent water companies compressing their stakeholder engagement and consultation into an unmanageably short period. and
- Thames Water, Anglian Water and Northumbrian Water worried whether the requirement for incumbent water companies to provide upfront charges was practicable in all cases. In their view, for some new connections, the work that has to be undertaken is too bespoke to be able to provide a reasonable estimate of the costs of undertaking these works.

Our expectations going forward

We support the work of the Water UK working group, albeit we note the concerns raised by some members and share their disappointment regarding slippage in its timetable. We encourage the sector to engage with the work of the group. That said, individual incumbent water companies remain responsible for implementation of our rules. Our rules require that, in going about implementation, water companies must undertake proportionate, timely and effective consultation.

In light of the concerns discussed above, we expect that incumbent water companies should:

- consider stakeholders' concerns which were raised as part of our March Review, discussed above.
- consider the work of the Water UK convened working group. For example, since effective consultation will require appropriate quantification of impacts, incumbent water companies should consider making use of the standardised approach which has been developed.
- publish their engagement plans as soon as possible and consider coordinating their stakeholder engagement. Incumbent water companies should share their plans with Water UK, so they can compile and publish them on their website. This will help both incumbent water companies and their stakeholders understand the timing of future consultations and plan their engagement accordingly.

We discuss the concerns related to upfront charges later in this chapter.

The level and changes to new connection charges

Our new connection charging rules are principle-based. We intend to maintain this approach, as it will provide incumbent water companies with the ability to innovate and take developers' needs into account when setting their new connection charges from 1 April 2018.

However, we had some concerns about new connection charges in terms of fairness, predictability and stability and on competition grounds. While we believe that we currently have in place a balanced and appropriate set of protections, we consider that incumbent water companies may benefit from further high-level guidance from us. This is provided below.

First, incumbent water companies should take all reasonable steps to ensure that the balance of costs (between developers and end-customers) is broadly maintained.

Any change in tariffs must also be in accordance with the principles of stability and predictability. We have also set in place a specific requirement for incumbent water companies in setting their new connection charges to balance their costs with revenues received, as far as is reasonably possible, over a rolling five-year cumulative period.

Second, some rebalancing may be required as a consequence of the new connections rules to be implemented from 1 April 2018. For example, the infrastructure charge may need to increase to reflect the inclusion of the cost of some offsite services currently included under the requisition charge. We expect such a readjustment to be a one-off event.

Third, we are also aware that incumbent water companies may have particularly strong incentives to set their charges for contestable services low to meet (or undercut) those set by their competitors, such as SLOs or NAVs. This is because, unlike in other sectors or context, they would not need to forego any revenues as they could simultaneously set higher charges for non-contestable services (i.e. infrastructure charges and/or end-customers' bills). This could negatively affect competition in contestable services.

Below we have examined whether our current rules are sufficient to address this concern.

We expect incumbent water companies to set charges, mindful of their strong market position and their responsibilities to comply with Competition Law. In addition, we expect the requirement to ensure that the balance of costs (between developers and end-customers) is broadly maintained should limit the incumbent water companies' ability to cross-subsidise from higher end-customers' bills. We had also introduced the 'five-year rule' from 1 April 2018, which requires that the revenues and expenditure related to infrastructure charges must balance over a rolling five-year period. We expect this to constrain the incumbent water companies' ability to raise their infrastructure charges in order to cross-subsidise lower contestable services' charges. However, this may act a partial constraint because:

- in the first few years (i.e. before we have a full five years of data), misalignments may occur between expenditure and revenues. This arises because the latter are not necessarily aligned over short periods. In these circumstances, any misalignments may not necessarily signal that infrastructure charges are above costs; and
- incumbent water companies have some freedom in allocating common costs, which could be used to justify changes in prices.

On the basis of the above considerations, we have concluded that, in addition to the existing guidance, we:

- need to be able to carefully monitor the level, and changes over time, of the contestable and non-contestable charges. To this purpose, we are currently **consulting** on introducing changes to our regulatory accounting guidelines to enable us to do so. Future changes to the reporting requirements may also be required to take account of the treatment and recording of income offsets. These will form part of future consultations on regulatory accounting guidelines; and
- will monitor trends in contestable and non-contestable charges. If it became evident that some of the concerns highlighted in this consultation arose, we are prepared to step in by either enforcing, or modifying our rules or, if appropriate, by using our Competition Act powers.

Our proposed amendment to our charging rules for new connections services – upfront charges

Our charging rules require incumbent water companies to set out their maximum charges in their Charging Arrangements. Water companies must explain how their charges have been calculated and their methodology for non-fixed charges. For requisition charges, companies must provide the option of a fixed charge but can also offer other approaches to set charges.

In response to our March Review and related engagement, Thames Water has argued for an exemption from the requirement to produce upfront charges but only when the services provided reflect exceptional circumstances, with key areas of concern relating to requisitions.

In particular, based on information from the energy sector, Thames Water argued for an exemption for services that are complex, infrequent or bespoke. An example which was often cited to us is that of a development alongside railways, rivers, canals, or near major roads, where the existing infrastructure is on the other side. Thames Water considered an exemption based on a pre-determined proportion of services (i.e. it argued for services accounting for 20 per cent of all new connection revenues not to be published upfront based on experience in the energy sector).

We continue to believe that there are substantial benefits from upfront publication in terms of transparency. In particular, we consider that prices have a critical role in providing the right signal to developers. Nonetheless, we accept that, in some circumstances, it may be unreasonable to require water companies to publish fixed

up front charges if costs are uncertain and difficult to estimate in advance. Requiring upfront publication in these circumstances may mean that prices may not reflect the underlying costs and would provide incorrect signals.

Therefore, we have considered both the type of exemption proposed by Thames Water and a principle-based approach relative to the current charging rules obligations – further detail on the pros and cons of these approaches can be found in Appendix A5.

We consider it appropriate to adopt a principle-based targeted exemption of upfront charges publication, whereby:

- Incumbent water companies are allowed to not publish upfront charges for requisitions where a reasonable, but exceptional and limited, set of circumstances exist.
- Customers should be able to understand that incumbent water companies' use of the exemption is appropriate and fair. This is the case if the exemption is used in a predictable and transparent way. So incumbent water companies should explain their reasons for applying an exemption, set out an objective criteria for using it and explain how it will apply.
- If a dispute arose, we will check for compliance with our rules, and the company will need to explain why they did not publish a charge and provide the evidence it has used to justify its decision;
- We will monitor the proportion of revenues from services with unpublished upfront charges. Water companies will be required to record the value of revenues for which there were no published upfront charges. Water companies are currently required to report the revenues of all services. In addition, we plan to introduce a requirement to separately report the amount of revenues for services for which they have not published upfront in their in their Annual Performance Report. This reporting requirement will be included as part of the consultation on regulatory reporting for the 2018-19 reporting year;
- If we saw that the proportion of revenues from services with unpublished charges was significant, we could consider whether this was appropriate and whether we would need to review our charging rules; and
- Water UK has initiated work to produce guidance on the application of this exemption, working with a range of stakeholders. We support this work. It could help to ensure the exemption is applied consistently and in a way that customer representatives consider is appropriate. As with Water UK's other guidance, we would expect this to be finalised soon to ensure it can feed into incumbent water companies' implementation.

On 23 May 2017, we informally consulted regarding the amendment to our rules, including the text of a revision to our charging rules and our intention to make it as a minor revision under section 144ZC of the Water Industry Act 1991. We received 16 responses from water companies, developer organisations and The Consumer Council for Water. Most responses support the amendment and agree the change is minor.

One water company and two developer organisations thought that the definition an exceptional circumstance needed to be clearer. In our view, our rule should remain principle-based and details around implementation are better developed and agreed by the sector.

We therefore intend to make a minor change to our charging rules for new connection services, and propose to make it as a minor revision under section 144ZC of the Water Industry Act 1991 (unless directed not to by the Secretary of State). In addition, we are mindful of a need for certainty on charging rules as soon as possible ahead of the implementation deadline, and a 'minor revision' is less time-consuming than a formal consultation. The revision we are making to our charging rules is set out in Appendix A6.

If appropriate, we will [amend our charging rules in the future if we see undue use of this exemption](#).

4. Proposed modifications to Condition C (Infrastructure Charges)

Our July 2016 consultation also set out a proposed modification to Condition C (Infrastructure Charges) of English water companies' appointments.

On 22 March 2017 the Secretary of State made the Water Act 2014 commencement order⁷ necessary to ensure that our charging rules apply to charges from 1 April 2018. In light of the transitional provisions in the commencement order, we are now consulting on an amended licence modification for English water companies other than NAVs with different transitional provisions.

We are also now consulting on a different licence modification for English water companies that are NAVs to simply delete Condition C of their appointments.

Licence Condition C concerns the maximum infrastructure charge that a water company can charge when a customer connects a new property to the public water or wastewater networks. It also gives water undertakers a duty to promptly inform the relevant sewerage undertaker of any new water customers that connect to the public water network.

We propose to make the modifications under section 55 of the Water Act 2014 and we are therefore consulting on the proposals in accordance with section 55(4) of the that Act. This section of the Water Act 2014 allows us to make changes to the licences of water companies where we consider it to be necessary or expedient to do so in consequence of provisions of the Water Act of 2014. We consider the proposed licence modifications to be necessary or expedient in consequence of provision made, in particular, by sections 16(2) and 17 of the Water Act 2014:

- Section 16(2) of the Water Act 2014 inserted sections 143B to 143E into the Water Industry Act 1991 ("WIA91"). Section 143B of the WIA91 allows Ofwat to issue rules about the statutory end-user charges schemes (which include infrastructure charges) made by water undertakers and sewerage undertakers under section 143 of the WIA91.
- Section 17 of the Water Act 2014 inserts sections 144ZA to 144ZD into the WIA91. Section 144ZA of the WIA91 (which is only in force in relation to English

⁷ [The Water Act 2014 \(Commencement No. 9 and Transitional Provisions\) Order 2017 \(SI 2017/462\)](#).

water companies) allows Ofwat to issue rules about (among other things) the charges that may be imposed by a relevant undertaker under:

- section 42(2)(a) of the WIA91 for the provision of new water mains; and
- section 99(2)(a) of the WIA91 for the provision of new public sewers.

Proposed modification to Condition C (Infrastructure Charges) for English water companies other than NAVs

The proposed modification of the text of Condition C is intended to remove the existing price cap on infrastructure charges from 1 April 2018, except where the requisition or adoption of the water main or public sewer being connected to would have been covered by the existing charging provisions in the Water Industry Act 1991 and not by Ofwat's new charging rules.

We consider that this change is necessary for two reasons. First, our new rules will move some costs currently covered through requisition charges to the infrastructure charge. Hence, the existing cap would no longer be appropriate. Second, instead of a cap, our rules will in future protect customers by requiring incumbent water companies to set cost-reflective infrastructure charges, i.e. to set charges to balance relevant costs and revenues over a rolling five-year period. The proposed Condition C modification intends to reflect these policy changes.

The proposed text of the amended licence modification we are now proposing for Condition C to reflect this need is in Appendix A7.

This licence modification that we are now consulting on is similar to the proposed licence modification that we consulted on in June 2016. The only changes are to the date on which the existing limits on infrastructure charges would be removed (which Ofwat also consulted on last year) and to the circumstances in which the existing limits would continue to apply after that date (the transitional provisions). The transitional provisions have been updated to reflect the wording of the transitional provisions in articles 14 and 15 of The Water Act 2014 ([Commencement No. 9 and Transitional Provisions](#)) Order 2017 (SI 2017/462), which was made in March 2017. The Water Industry Act 1991 does not explicitly allow sewerage undertakers to recover network reinforcement costs under a sewer adoption agreement, but it is sensible for the transitional provisions for water and sewerage to mirror each other and the provisions in the commencement order.

Proposed modification to Condition C (Infrastructure Charges) for English water companies that are NAVs

Currently, all water companies (including NAVs) have a Condition C which imposes the same limits on the level of infrastructure charges. However English water companies that are NAVs are also currently subject to a relative price cap (paragraph 1A of Condition B (Charges) of their appointments) which restricts them from setting charges in charges schemes that are greater than those of the incumbent water company or companies they replace. As a result, the limits on infrastructure charges set by Condition C do not in practice provide any additional protection for the customers of a NAV, as Condition B already requires it not to set any higher infrastructure charges than those of the relevant incumbent water company.

In the interests of simplification, we therefore propose to modify the appointments of English water companies that are NAVs by simply deleting Condition C. The companies that this modification would apply to are as follows:

- Albion Water Limited;
- Icosa Water Services Limited;
- Independent Water Networks Limited;
- Peel Water Networks Limited;
- Severn Trent Services (Water and Sewerage) Limited;
- SSE Water Limited; and
- Veolia Water Projects Limited.

With the removal of Condition C, customers of NAVs would still retain the full protection from overcharging of infrastructure charges provided by the relative price cap which restricts NAVs from setting charges in charges schemes that are greater than those of the incumbent water company or companies they replace.

However we note that this proposal will mean that, in the period before 1 April 2018, we would not be able to determine any disputes about the calculation of the Relevant Multiplier where Condition C would otherwise require infrastructure charges to be calculated by reference to it.

The Relevant Multiplier is used to calculate the amount of an infrastructure charge for the connection of premises other than dwelling houses or flats if water is provided by a supply pipe with an internal diameter larger than the standard size used for new connections of houses. Condition C currently allows us to determine disputes about the calculation of the Relevant Multiplier. The removal of Condition C would mean that companies are no longer required to use the Relevant Multiplier approach. (Our

above proposals will also, subject to the transitional provisions, make this the case for other English water companies from 1 April 2018.) Any disputes about the calculation of infrastructure charges in individual cases that could not be resolved between the parties would have to be resolved either through WATRS or the courts. In practice, we do not believe that this is likely to have much, if any, actual impact on customers of NAVs because of the nature of the areas that the NAVs serve (mainly housing developments) and because we are rarely asked to make such determinations. We have not been asked to make such a determination in the last five years.

Other possible licence modifications

We also recognise that some concerns have been raised regarding the removal of paragraph 9 of Condition C which places an obligation on water undertakers, where premises are connected to a water supply, to provide certain information to the relevant sewerage undertaker. We recognise the value in retaining an equivalent obligation. We have therefore written to the companies as part of our licence simplification work setting out our proposal to retain this obligation as part of a different licence condition.

Finally, we note that paragraphs 1 and 4 of licence condition D (Charges Schemes) currently require water companies to allow customers for the option of paying infrastructure charges over a 12 year period. As part of our ongoing work on licence simplification, we will be considering whether this licence condition is still necessary once the changes to infrastructure charges have been implemented.

5. Next Steps

Subject to any further input and evidence we receive from stakeholders, we plan to finalise and publish our proposed licence modifications and further changes to charging rules that we are consulting on. We welcome your views on our proposals and in particular feedback on the specific questions below.

Questions

Q1 Do you agree that our Option 3 on the treatment of the income offset/asset payments, has merit? If not, please explain your reasoning and provide relevant evidence. If so, how and when should this change be brought about?

Q2 Do you agree with our draft impact assessment? Can you provide quantitative figures in terms of the potential benefits or costs? Is there anything we have missed?

Q3 Do you have any comments on the drafting of the possible future changes to our rules (set out in Appendices A3 and A4)?

Q4 Do you have any comments on our proposed licence modification to Condition C (Infrastructure Charges) for English water companies other than NAVs (including the proposed wording set out in Appendix A7)?

Consistent with provisions of Water Act 2014, we will publish amended new connection charging rules to give effect to our planned, minor change (unless directed not to by the Secretary of State) by **5pm on 4 August 2017**.

Once the Welsh Government has published their supplementary charging guidance we will develop new connections charging rules for Welsh water companies.

A1 Proposed changes to our rules from April 2020 – Impact Assessment for Consultation

1.1 Introduction

We have identified some concerns about the current treatment of the income offset (see Chapter 2). We are therefore considering some options that consider both alternative ways to treat the income offset/asset payments and the timing of their implementation. Our base scenario is the status quo consisting of the set of rules we published in our [charging rules for new connections: decision document](#) (December 2016). These will be implemented by 1 April 2018.

In carrying out this impact assessment for consultation, we have also taken our [final Impact Assessment for new connections charging rules](#) into account.

This Appendix provides further information on our analysis.

1.2 Background

Incumbent water companies may (but are not required to) apply income offsets and asset payments for the provision of on-site assets. We understand that currently, income offsets and asset payments are set against requisition charges. This means that they are offered directly or indirectly as a discount to developers against the requisition charge or costs. Table 2 shows what developers pay for on-site work and the discount they are offered by the incumbent water company. While an income offset (or asset payment) is provided to developers when they, SLOs or the incumbent water company undertakes the work, NAVs are rarely, if ever, offered an income offset by incumbent water companies.

According to our new connection rules (which will come into effect from 1 April 2018), incumbent water companies must set charges (including income offsets and asset payments) in a way that promotes effective competition for contestable work and ensure asset payments are equivalent to income offsets. In addition, [Defra's charging guidance](#) sets out the principles that incumbent water companies should broadly maintain the present balance of charges between developers and end-customers prior to the implementation of these rules.

Table 2: On-site discounts under new connections charging rules published in December 2016⁸

Who undertakes on-site works	Discount	What developers pay
Incumbent water companies	Incumbent water companies may give developers an income offset for water and wastewater assets	Water and wastewater assets = (Requisition charge – income offset)
SLOs	Incumbent water companies give SLOs an asset payment for water or wastewater assets equivalent to any income offset that would have been paid by the incumbent water companies (SLOs usually pass on the asset payment to developers through reduced on-site charges)	Water and wastewater assets = (gross on-site SLOs charges – asset payment)
Developers	Incumbent water companies give developers an asset payment for water or wastewater assets . Incumbent water companies have a choice of giving asset payment for wastewater assets	Water and wastewater assets = (on-site costs – asset payment)
NAVs	No asset payments or income offsets, but a small minority of NAVs receive discounts via their bulk supply charge equivalent to income offsets/asset payments	Water and wastewater assets = (on-site charge – discount equivalent or similar to income offset/asset payment ⁹)

⁸ This is a stylised representation of new connections charges in order to bring out key differences and relations between charging structures. In addition, developers will often pay a connection charge and an infrastructure charge.

⁹ We assume that the NAV aims to discount their on-site charges by a figure equivalent to the income offset/asset payment, in order to compete with other providers.

1.3 Rationale for intervention

Stakeholders' concerns over current arrangements

We have engaged with stakeholders who have raised a number of concerns over current charging arrangements related to the income offset.

SLOs have told us there is a lack of transparency over the application of asset payments.

NAVs have argued that, unlike SLOs (and incumbent water companies), they often do not receive an asset payment (or benefit from an income offset). This means that when they bid for the developers' on-site work they do not benefit from the same discount offered to developers by SLOs and incumbents. From our informal information request, 13 out of 15 the companies that responded do not provide NAVs with discounts equivalent to income offsets and asset payments. This makes the playing field for on-site services between NAVs and competitors (SLOs and incumbent water companies) uneven.

An incumbent water company also raised some concerns. It argued that the current arrangements are unfair as the income offset only applies to new connections that require a requisition – i.e. for which a requisition charge is paid. This often means that only some and larger developers typically benefit from the on-site discounts. Separately, it has also argued that for some incumbent water companies the income offset amounts to around 85-90% of the gross requisition charges. This means that the net requisition charges cannot reflect the cost of requisition and do not send appropriate price signals and developers often build in areas that are expensive and difficult to connect. It argued that this increases the costs for incumbent water companies and potentially end-customers through the cost sharing mechanism.¹⁰

Market failures and inefficiencies

In the light of stakeholders' comments and our own analysis, we consider that currently, the treatment of the income offset and asset payments raises a number of concerns.

¹⁰ If the costs of the incumbent water companies are higher than envisaged, the overrun in cost is shared roughly equally between customers and investors. This means incumbent companies can charge customers to recover 50% of their cost overrun.

First, it does not ensure a level playing field because it does offer the same discounts to NAVs when they undertake the work. It places the majority of NAVs at a disadvantage when competing to provide on-site services to developers. We have noted that in the water sector third party providers, such as NAVs, have a significantly lower share of providing on-site services to new developments than, for example, is the case of services in the energy or telecommunications sectors. An uneven playing field reduces effective competition and is likely to lead to inefficiencies in the form of reduced choice, higher prices, less innovation and lower quality services for developers. End-customers may also be worse-off as, for example, NAVs often offer a discount (and in some case innovative solutions) relative to the water incumbents' charges to end-customers.

Second, the current treatment of the income offset is unlikely, in theory, to send efficient price signals to developers. As mentioned above, the income offset can often be a large proportion of the requisition charge, substantially reducing the level of the net requisition charge. The level of the latter should reflect the local costs and, hence, provide price signals to developers as to the relative cost of building the on-site infrastructure. However, currently, because of the income offset, the net requisition charge may not provide strong price signals. For example, a developer might choose to build in a high cost area, rather than a lower cost area, because there is little or no difference in the relative net requisition charges. While this is a concern, in practice we recognise that requisition costs are likely to be a fraction of the total costs facing a developer, so the materiality of this effect is unlikely to be substantial.

Third, currently the income offset is only paid when a requisition charge is raised. As this is not always the case, the current approach may only benefit some developments and not others.

2.1 Assessment criteria

In order to appropriately assess the relative advantages and disadvantages of the options, we have identified what we consider are the most appropriate assessment criteria. We have assessed these options against all of our statutory duties. We did so in the context of Ofwat's duties under Section 2 of the Water Industry Act 1991 (including our duty to further the consumer objective to, in summary, protect the interest of consumers, wherever appropriate by promoting effective competition). We have also had regard to [Defra's charging guidance](#). In the light of our duties, we consider that the most relevant assessment criteria are:

- **Competition** - does the option promote competition in the provision of on-site services? Would this lead to benefits for developers and end-customers?
- **Efficiency** - does the option provide clear signals that encourage efficient decisions by developers?
- **Consumer protection** - does the option have any unintended consequences?
- **Good regulation** - is the option proportionate and targeted? Does the option ensure transparency and predictability for all parties involved? Does the option raise implementation, on-going and/or unnecessary dispute costs?

We have also considered the distributional impacts of each options relative to the status quo. In particular, we have assessed whether the options negatively impact particular groups of stakeholders. Appendix A2 sets out an analysis of stakeholders that we consider winners and losers in each option.

2.2 Options

Given the concerns with the status quo, we have identified a number of options that could potentially improve outcomes for developers and end-customers. These options differ both in the way in which a level playing field is created – i.e. how to ensure that NAVs are not at a disadvantage relative to other providers – and when the changes are implemented.

We have therefore identified the following options.

Table 3: Options

	Option 1 (status quo)	Option 2a	Option 2b	Option 3
Treatment of Income Offset and Asset Payments	The income offsets and asset payments would continue to be set against the requisition charge only.	The income offset would be netted off the infrastructure charge instead of the requisition charge. Therefore, all, or almost all, new connections would receive the income offsets. There would also be no longer a need for asset payments, as income offsets would replace asset payments.		For the period 2018-2020, the income offsets would be included in the new bulk supply agreements between NAVs and incumbent water companies. From 2020, the same arrangements as under option 2b.
Implementation Date	Already in place.	1 April 2018.	1 April 2020.	1 April 2020.

2.3 Option appraisal

We have assessed Options 2a, 2b and 3 against the status quo (Option 1). Our assessment is mainly qualitative, though we have attempted to quantify some effects when relevant and appropriate.

Option 2a – income offset is netted against the infrastructure charge and implemented as of 1 April 2018

Competition

Option 2a promotes more effective competition relative to the status quo. Responses to our informal information request have highlighted that currently, only a small minority of NAVs receive a discount via their bulk supply agreements with incumbent water companies. This puts them at a disadvantage when competing for on-site works against incumbent water companies and SLOs. Option 2a is an improvement as moving the income offset discount to the infrastructure charge means all NAVs, SLOs and incumbent companies will be on a level playing field for on-site works. We consider that increased competition from NAVs is likely to result in more choice for developers, as NAVs would be more likely to bid for developers' work. This in turn may lead to cheaper prices and better quality of services for developers. In addition,

end-customers may also benefit, given that NAVs sometimes also offer discounts on the incumbent water companies' tariffs, good customer service and innovative solutions. We consider this to be important benefit from this option.

Efficiency

Moving the income offset against the infrastructure charge means requisition charges may provide better price signals to developers relative to the status quo as discussed in Section 1.3. As a result, the requisition charge will no longer be net of the income offset and will reflect the relative on-site costs. In theory, developers will have incentives to build in areas that are cheaper to connect. This reduces the likelihood of incumbent water companies having to charge end-customers higher bills via the cost sharing mechanism when the income offset is set against the requisition charge. While this is potentially a benefit, in practice it is unclear whether developers' location decisions are significantly affected by the level of the requisition charge. Hence, it may be a small benefit.

Consumer protection

In our December 2016 decision document we identified a potential concern if we implemented Option 2a from 1 April 2018 in the form of higher, but temporary, end-customers' bill.

Under Option 2a asset payments would no longer exist and would be replaced by income offsets to be paid to SLOs. While this effect should be neutral with asset payments being replaced by equivalent income offsets, this is not the case given the way in which price controls currently work. This change would be recorded as a reduction in the incumbent water companies' wholesale revenues and capital costs. In particular:

- Revenues would be reduced because the incumbent water companies would offer more discounts in the form of income offsets to developers. The incumbent water companies would be entitled to recover this revenue shortfall in the next revenue control period. The revenue impact would only cover two years of PR19,

and would be recovered from end-customers via higher bills in 2020/21 and 2021/22;¹¹ and

- Capital costs would decline because asset payments, which are recorded as capital costs, would no longer exist. The benefits from a reduction in totex expenditure are split between the incumbent water company and the end-customer in accordance with the totex cost sharing mechanism. Hence, end-customers will receive their proportion over the following 5-year Asset Management Period (AMP).

In order to assess this impact, we requested information from incumbent water companies on the total values of their asset payments, income offsets and number of connections for the years 2014/15 and 2015/16. We received data from 15 out of 16 incumbent water companies in England. We have used these figures to broadly estimate the impact for the water industry. In our estimations we assumed that the number of end-customers, the value of the asset payments and the revenue increase in line with water companies' growth forecasts from their PR14 business plans.¹² We have expressed asset payment values in 2017/18 prices for the water industry.

We have separately estimated:

- The total yearly wholesale revenue impact by using the average yearly asset payments divided by the average number of years asset payments are spread over. Although we asked for information on the average number of years over which asset payments are calculated, we had concerns about the quality of the responses provided. As a result, we undertook sensitivity analysis over the average number of years, which asset payments are calculated (i.e. 12, 8 and 4 years); and
- The totex impact by using the average asset payments and applying the totex cost sharing mechanism, which is a combination of a reduction in the incumbent water companies' Regulated Capital Value (RCV) and a reduction in end-

¹¹ The Wholesale Forecasting Revenue Incentive Mechanism (WFRIM), which is an annual reconciliation of the actual revenue versus the amount allowed in the Final Determination. The mechanism operates on a two-year delay cycle - i.e. adjustments relating to 2018/19 would be reflected in the end-customers' bills for 2020/21.

¹² In PR14 business plan tables, incumbent water companies forecasted growth of number of new connections across the industry at 3% per year from 2018-2020. We assume constant growth at 3% per year in 2020-2022.

customers' bills for the following AMP. It was assumed that the benefit to customers was spread evenly over the AMP to avoid year on year fluctuations.

Table 4 shows the impact on end-customers' bills in 2017/18 prices under our sensitivity scenarios. It shows the estimated increases in end-customers' bills as industry yearly totals and on per end-customer basis (expressed as total and as a percentage of the average end-customer's bill).

Table 4: Average yearly increases in end-customers' bills for 2020/21 and 2021/22 under Option 2a (in 2017/18 prices)

Impact	£ per year
£ industry combined wholesale revenue and totex impact	4 years = £5,200,700 8 years = £1,800,200 12 years = £600,700
£ average net increase per customer bill	4 years = £0.19 8 years = £0.07 12 years = £0.02
% annual increase per average customer bill	4 years = 0.06% 8 years = 0.02% 12 years = 0.01%

This is a cost for Option 2a which would not arise under the status quo.

Good regulation

Option 2a is more targeted, proportionate, transparent and predictable than the status quo. As the infrastructure charge is paid for any new premise, developers will receive an income offset for each new premise, whereas currently they only receive it when the on-site infrastructure is requisitioned. As a result, under Option 2a the income offset will become more predictable, targeted and transparent. We consider this to be more in line with the aim of the income offset.

An implication of Option 2a is that moving the income offset to the infrastructure charge will mean that we will not be able to determine disputes between customers and incumbent water companies over the income offset. This is because Ofwat will not have powers to determine disputes between customers and incumbent water companies over the level of infrastructure charges when the new rules come into effect. These disputes can be adjudicated by water redress scheme if the dispute is less than £10,000 for household customers or £25,000 for non-household

customers.¹³ Larger disputes can be resolved through the court system in the same way as most billing disputes in the water and wastewater sector work.

In the long term, we expect the regulatory burden for the industry to be lower under Option 2a than under the status quo. This is because the income offset would be better targeted, more proportionate, transparent and predictable and hence cheaper and easier to administer for incumbent water companies, SLOs, NAVs and developers. We expect that the added clarity should reduce the level of disputes in the industry.

However, in the short term, there may be some one-off implementation costs for incumbent water companies, such as developing new charges, updating their IT systems, consulting, accounting and legal costs. We consider that given the implementation date of 1 April 2018 these costs will not be insignificant. Nonetheless, overall we consider that the long-term benefits will be larger than the short run implementation costs.

Option 2b – income offset against the infrastructure charge and implemented as of 1 April 2020

This option is identical to Option 2a, but for its implementation date which is two years later. This has two main effects relative to Option 2a:

- Later implementation has the advantage of not raising concerns about temporary increases in end-customers' bills. It also reduces the short-term implementation costs as incumbent water companies would have more time to implement changes; and
- Under Option 2b, the benefits in terms of competition, efficiency, good regulation and long term regulatory cost and burden will only accrue two years later – i.e. there will be two years less of benefits.

We have undertaken further high level quantitative analysis to estimate the main trade-off between Options 2a and 2b. Relative to Option 2a, under Option 2b:

¹³ WATRS is the water redress scheme that independently settles disputes between customers and the water and wastewater companies or suppliers of England and Wales.
<https://www.watrs.org/>

- Developers will not enjoy the benefits of more intense competition for two years (2018/19 and 2019/20). This is a cost under Option 2b; but
- End-customers will not face increases in their bills for the years 2020/21 and 2021/2022 due to the way asset payments and income offsets are treated in the price controls. This is a benefit under Option 2b.

For this quantification exercise we have only focused on benefits from early adoption in terms of lower developers' charges from increased competition.¹⁴ More specifically, we expect Option 2a would lead to more competition from NAVs to offer on-site delivery services to developers in the years 2018/19 and 2019/20. This is expected to put pressure on the incumbent water companies' requisition and connection charges.

We consider that it is not possible to reliably quantify the impact of early adoption in terms of lower charges for developers from more intense competition for the years 2018/19 and 2019/20. However, we have estimated the percentage price reduction for developers' services in the years 2018/19 and 2019/20 that would be required in order to offset the overall estimated (temporary) increase in end-customers' bills expected from early implementation.

Under Option 2a, we estimated that the total impact on end-customers' bills would range from £1.2 million to £10.5 million in 2017/18 prices. This covers two years of estimated end-customers' bill increases and the range reflect the assumptions used in Table 4 on the average number of years, over which asset payments are calculated.

Next we estimated the level of requisition and connection charges (paid by developers) that we expect to be levied in the years 2018/19 and 2019/20 and expressed them in 2017/18 prices. We have assumed that the requisition charges and connection charges from APR from 2015/16 will increase in line with the incumbent water companies' new connection growth forecasts from their business plan forecasts for PR14. We also reduced the requisition charge as from 1 April 2018, it will no longer include some off-site costs. As we are not able to precisely forecast this reduction, we have undertaken some sensitivity analysis, assuming that the requisition charge would decline by 10, 40 and 80% respectively.

¹⁴ More intense competition may not only lead to lower charges for developers, but also higher quality services and it may also lead to better and cheaper services for end-customers. Option 2a's early implementation may also generate other benefits. This quantification of the trade-off only focuses on the competition benefits in the form of lower charges for developers.

Table 5 below shows the results under our sensitivity scenarios. It indicates that developers' on-site charges (connection charges plus requisition charges) would need to be 0.4 to 4.3% cheaper per year (under Option 2a relative to 2b) between 1 April 2018 and 1 April 2020 in order to offset the estimated impact of end-customers' bills (occurring in 2020/21 and 2021/22). Therefore, for this trade-off only, Option 2a is to be preferred, if, for the years 2018/19 and 2019/20, Option 2a leads to developers' prices that are between 0.4 to 4.3% lower than the prices expected under Option 2b.

We do not consider it is necessary in this case to reach a conclusion on whether early implementation is likely to result in gains from competition (for services to developers) which outweigh the (temporary) impact on end-customers bills. This is because Option 3 will avoid increases in end-customers' bills

Table 5: Annual reductions in connection and requisition charges under Option 2b to offset impact on customers' bills under Option 2a (in 2017/18 prices)

Assumed percentage reduction in requisition charge	Average number of years = 4	Average number of years = 8	Average number of years = 12
-10%	3.4%	1.2%	0.4%
-40%	3.7%	1.3%	0.5%
-80%	4.3%	1.5%	0.5%

Option 3 – As Option 2b but adjust the bulk supply price to NAVs to include income offset from 1 April 2018 to 1 April 2020

Option 3 aims at avoiding the increase in end-customers' bills that we consider likely under Option 2a. At the same time, it aims at not postponing to 1 April 2020 the competition benefits from offsetting the income offset against the requisition charge under Option 2b.

It can achieve this by introducing the change by 1 April 2020, but also introduce a temporary measure ensuring that the competition benefits from early implementation are achieved from 1 April 2018. This temporary measure consists of requiring incumbent water companies to provide income offsets to NAVs as part of their bulk supply agreements only for the years 2018/19 and 2019/20.

Competition

Option 3 performs similarly to Option 2a, as it achieves the levelling of the playing fields as early as 1 April 2018. As a result, it performs better than the status quo and Option 2b, which postpone the benefits from competition to 1 April 2020.

Efficiency

Under Option 2a moving the income offset against the infrastructure charge means the requisition charges could provide better price signals for developers relative to the status quo. This is because requisition charges (no longer net of the income offset) would become more cost reflective without any discounts set against them. However, it is unclear whether the requisition charge materially affect developers' location choices. Therefore, we expect this to be a small benefit. Option 3 is expected to perform like Option 2b in terms of efficiency. This is because for the years 2018/19 and 2019/20 the income offset will be offset against the requisition charge meaning that the strength of the price signals remain as under the status quo.

Consumer protection

Unlike Option 2a, under Option 3 there will be no negative impact on end-customers' bills as a result of replacing asset payments to SLOs with income offsets. This is because bulk supply charges are outside the price control and there is no need to remove the asset payments.

Good regulation

Option 3 is more targeted and proportionate than the status quo and is as targeted and proportionate as Option 2b. However, we consider that this option is likely to perform worse in terms of transparency than Option 2a (and 2b, but better than the status quo), though this disadvantage is only for two years. This is because the bulk supply charges are unrelated to new connections and bundling them together would make the income offset less transparent.

Option 3 performs like Option 2b (and better than Option 2a) in terms of short run costs, as the changes are introduced from 1 April 2020, providing sufficient time to the incumbent water companies to implement the change. However, in terms of long terms costs, we consider that it would be similar to Option 2a as including the income offset under the the bulk supply agreements for NAVs should provide clarity and reduce the likelihood of disputes from 1 April 2018.

Our preferred option

Our provisional conclusion is that we have a preference for Option 3 as it allows to obtain the largest majority of the benefits from early implementation (in a similar way to Option 2a), but it avoids the costs in terms of temporary increases in end-customers' bills from early implementation from 1 April 2018.

A2: Distributional impacts

Table 6 assesses the impacts by stakeholder groups. We have not identified any categories of vulnerable end-customers that are likely to be negatively affected by our proposal.

The impacts of Option 2a and 2b are similar except under the latter they start two years later. There are two main exceptions. First, incumbent water companies would incur early implementation costs under Option 2a but not under 2b. Second, end-customers' bills are likely to rise under Option 2a, but not under Option 2b. Option 3 both avoids an increase in end-customers' bills and achieves the competition benefits from early implementation in the form of lower connection and requisition charges.

Table 6: distributional impacts of Options

Stakeholder	Impact of Option 2a	Impact of Option 2b	Impact of Option 3
Developers	Developers would have greater choice and may benefit from increased competition. This may lead to lower development prices from 1 April 2018. Income offset would be paid to most, if not all, developers. Those who did not receive it will benefit, those who would receive it under the status quo may lose. This is because the average income offset may decline as a result of being paid to most, if not all, developers.	Same as Option 2a but only starting from 1 April 2020.	Similar* to Option 2a.
End-customers	End-customers may benefit from the environmentally innovative solutions or lower bills that NAVs may be able to offer from 1 April 2018. However, end-customers may face temporary bill increases for a two year period as this change is implemented during PR14. This may offset some of the benefits from cheaper NAVs services.	Option 2b is introduced at the start of the next price control, hence end-customers' bills are protected. All the benefits of Option 2a would be realised only from 1 April 2020.	Similar* to Option 2b, end-customers' bills are protected but, like Option 2a, competition benefits are realised early on from April 1 2018.
NAVs	NAVs may benefit because they would be on a more level playing field when competing with other on-site providers from 2018.	Same as Option 2a, but NAVs would benefit only from 1 April 2020.	Similar* to Option 2a.

Stakeholder	Impact of Option 2a	Impact of Option 2b	Impact of Option 3
SLOs	SLOs would face more competition from NAVs, but benefit from greater transparency over on-site charges and from lower administrative costs due to no asset payments.	Same effects as Option 2a but only from 1 April 2020.	Similar* to Option 2a.
Incumbent water companies	Incumbent water companies would face more competition from NAVs from 1 April 2018 and some additional costs due to tight timescales for implementation.	Incumbent water companies may face more competition from 1 April 2020. They may also face lower implementation costs (relative to Option 2a) due to delayed implementation.	Similar* to Option 2a in terms of competition. Same implementation costs as Option 2b, though perhaps some very small costs for new bulk supply charges for the 2018-2020 period.

** We use the term “similar” because while under Option 2a changes would be implemented from 1 April 2018, under Option 3 the same changes will apply from 1 April 2020. However, under Option 3 for the previous two years, incumbent water companies would level the level playing field by including the income offset in their bulk supply agreements with NAVs. This is a less transparent option to offsetting the income offset against the infrastructure charge.*

A3: Proposed changes to our rules from April 2020 : Revision to our charging rules for new connections

Extant Rule Number	Proposed change to drafting	Rationale
5b	b) “ Charging Arrangements ” means a document setting out the charges, Income Offsets and Asset Payments , and/or the methodologies for calculating those, applied by the water or sewerage undertaker in accordance with these rules.	Asset payments are no longer needed and should not be offered. References to income offsets would be transferred to our Charges Scheme rules.
17a, 17b	<p>These rules apply to a Small Company subject to the following provisions:</p> <p>a) a Small Company is not required to publish one or more of the charges or Asset Payments covered by these rules (or a methodology for calculating them) where it would be unreasonable to expect the company to do so (having had regard to the number of requests for the relevant services that the company would reasonably expect to receive);</p> <p>b) the charges imposed, or Asset Payments made, by a Small Company under the provisions of the Water Industry Act 1991 covered by these rules must be calculated in accordance with the principles and requirements set out in these rules whether or not they are published in Charging Arrangements and this includes, where relevant, requirements to provide the option of upfront Fixed Charges;</p>	Asset payments are no longer needed and should not be offered.
21	Charges (including any Income Offsets), any Asset Payments and arrangements for when they are each payable must be set in accordance with the principle that they should promote effective competition for Contestable Work.	Asset payments are no longer needed and should not be offered.

		References to income offsets would be transferred to our Charges Scheme rules.
29	In setting Requisition Charges an undertaker may (but is not required to) provide for an Income Offset. Undertakers shall not provide for Income Offsets in setting Requisition Charges.	Income offsets are to be set against the infrastructure charge instead. Ensuring that income offsets are not set against requisition charges.
30	As regards the methodology for the calculation of Income Offsetting arrangements: a) Each undertaker has discretion as to the methodology to be applied to calculate an Income Offset. Such methodology must, however, be clearly explained in the applicable Charging Arrangements; b) In addition as regards Water Mains, the methodology for the calculation of any Income Offset applied in respect of requisitioning charges must be equivalent to the methodology applied in calculating any Asset Payment an undertaker may make in respect of the adoption of Water Mains and c) Nothing in these rules prevents an undertaker from providing for Income Offsetting arrangements in relation to the requisition of Public Sewers if it does not make any Asset Payments in respect of the adoption of Sewers. But if the undertaker does make Asset Payments in respect of the adoption of Sewers or Lateral Drains then the methodology for the calculation of any Income Offset applied in respect of Requisition Charges must be equivalent to the methodology applied in calculating any such Asset Payment.	No longer needed. Equivalent provision would be included in Charges Scheme Rules where relevant.
35	Each undertaker shall set out in the applicable Charging Arrangements the charges to be imposed and the Asset Payments, if any, to be made in respect	Asset payments are

	of an agreement under section 51A or section 104 of the Water Industry Act 1991.	no longer needed.
38	Insofar as section 51A agreements are concerned, water undertakers are not required to make any Asset Payments. shall provide for Asset Payments where the undertaker calculates the requisition charge for a Water Main to include an Income Offsetting arrangement.	Asset payments are no longer needed and should not be offered.
39	Insofar as section 104 agreements are concerned, sewerage undertakers are not required to make any Asset Payments may provide for Asset Payments for the adoption of a Sewer.	Asset payments are no longer needed and should not be offered.
40	Where an undertaker provides for Asset Payments in respect of the adoption of a Water Main pursuant to an agreement under section 51A of the Water Industry Act 1991, or the adoption of a Sewer pursuant to an agreement under section 104 of the Water Industry Act 1991, the calculation of any Asset Payment must be equivalent to the methodology applied in calculating an Income Offset applied in respect of Requisition Charges.	Asset payments are no longer needed, so this rule is redundant.

A4: Proposed changes to our rules from April 2020 : Revision to our Charges Scheme rules

Extant Rule Number	Proposed change to drafting	Rationale
5	<p>“Income Offset” means a sum of money offset against the Infrastructure Charge that would otherwise apply in recognition of revenue likely to be received by the relevant undertaker in future years for the provision of:</p> <p>i. supplies of water to the premises connected (in the case of a Water Infrastructure Charge); or</p> <p>ii. sewerage services to the premises (in the case of a Sewerage Infrastructure Charge;</p> <p>“Sewerage Infrastructure Charge” means such a charge as is described in section 142(2)(b) of the Water Industry Act 1991;</p> <p>“Water Infrastructure Charge” means such a charge as is described in section 142(2)(a) of the Water Industry Act 1991.</p>	<p>Any income offset must be set against the infrastructure charge, so a definition is required within the Charge Scheme Rules.</p> <p>Supporting definitions also inserted.</p>
New rule	<p>In determining the amount of Infrastructure Charges a relevant undertaker may (but is not required to) provide for an Income Offset. Each relevant undertaker has discretion as to the methodology to be applied to calculate an Income Offset. Such methodology must, however, be clearly explained in the applicable charges scheme.</p>	<p>This gives effect to our proposal for the income offset to be set against the infrastructure charge, rather than the requisition charge.</p>
New rule	<p>Infrastructure Charges must be determined in accordance with the principle that reasonable steps should be taken to ensure that the balance of charges prior to December 2016 between Developers (as that term is defined in the charging rules for new connection services issued by the Water Services Regulation Authority under sections 51CD, 105ZF and</p>	<p>This gives effect to our proposal for the income offset to be set against the infrastructure</p>

	<p>144ZA of the Water Industry Act 1991) and other customers is broadly maintained. This general requirement may only be departed from where (and to the extent that) this is rendered necessary by circumstances providing clear objective justification for doing so.</p>	<p>charge, rather than the requisition charge.</p>
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A5: Upfront charges – assessment of approaches

Our charging rules requiring the upfront publication of charges were introduced to ensure price transparency and improve the predictability of costs likely to be faced by developers. These rules also avoid perceptions of undue discrimination. Our rules also provide flexibility in companies' approaches, as they explicitly enable incumbent water companies to introduce alternative ways for calculating charges that do not involve upfront charges.

However, some stakeholders argued that an exemption should be allowed in exceptional circumstances, with key areas of concern relating to requisitions. In particular, based on information from the energy sector, Thames Water argued for an exemption when services are bespoke and whose costs are inherently unpredictable. These could, for example, include services that are complex, infrequent and bespoke, such as development alongside railways, rivers, canals, or near major roads, where the existing drainage is on the other side. Thames Water considered an exemption based on a pre-determined proportion of services (i.e. services accounting for 20 per cent of all new connection revenues not to be published upfront based on the experience in energy).

We recognise that where some services' costs are unpredictable, upfront prices are unlikely to accurately reflect the true costs. This means that:

- developers are not given efficient price signals, and this may result in them making inefficient choices;
- winners and losers are created, leading to distributional issues and perceived unfairness;
- competition issues, for example, as the price might be unduly high or low relative to others' prices; and
- a needlessly large number of complaints/disputes could arise.

Accounting for the concerns raised by stakeholders, we have considered two alternative approaches to the existing obligation to publish upfront all charges:

- **Approach 1:** clarify existing rules, including specifying the principles which allow for a reasonable but exceptional and limited set of circumstances not to publish; and

- **Approach 2:** restrict publication requirement to at least X% of revenues from certain services

Approach 1 addresses the concerns above in a proportionate, flexible and targeted way, whilst ensuring price transparency and predictability where appropriate. A principle-based, targeted exemption from upfront charges publication can mitigate the risk of developers making the wrong choices. This approach involves:

- **Monitoring how companies apply this exemption through their Annual Performance Reports.** This will give us assurance to customers and ourselves that companies are using the this exemption appropriately; and
- **Industry-led guidance on the appropriate application of this exemption.** Water UK plan to produce this guidance, working with stakeholders. The intention of this is to help ensure the exemption is applied consistently and in a way that customer representatives consider is appropriate.

Approach 2 also addresses the concerns above. Water companies' implementation costs would be relatively low and it would be easily understood. However, the proportion ('X%') would be difficult to set accurately and if it were set too cautiously would run the risk of too few services having an upfront price. Also, water companies might game the exemption by not publishing prices for services where they face stronger competition.

Considering the advantages and disadvantages of the above approaches, we have concluded in favour of Approach 1.

A6: Revision to our Charging Rules for New Connection Services (English Undertakers)

Insert after paragraph 46:

“Exception from requirements to provide upfront Fixed Charges

47. Undertakers are not required to provide for the option of upfront Fixed Charges in accordance with paragraphs 25 (Requisition Charges) of these rules, or to comply with paragraph 14, where, and to the extent that, it would be unreasonable to expect an undertaker to do so (having had regard to the practicality of setting a cost-reflective upfront Fixed Charge and the benefit to customers of producing such a charge).
48. Where paragraph 47 applies, an undertaker must set out, and explain clearly, in its Charging Arrangements the alternative method or methods that will apply for calculating charges.”

A7: Proposed Modification to Condition C (Infrastructure Charges) for English Water companies other than NAVs

Insert after paragraph 15:

“16 Cessation of this Condition

- 16.1 Subject to sub-paragraph 16.2, this Condition (including the Appendix) shall cease to have effect on 1 April 2018 and shall not limit the amount of any Infrastructure Charge in respect of each Charging Year starting on or after that date.
- 16.2 This Condition (including the Appendix) shall continue to have effect in relation to a connection made on or after 1 April 2018 in the following circumstances:
- (a) in relation to a Water Infrastructure Charge, if the premises are connected to a water main that:
- (i) was provided by a water undertaker under section 41 of the Water Industry Act 1991 and the charges for that water main were calculated on the basis of the provisions of the Water Industry Act 1991 before they were amended by the Water Act 2014; or
 - (ii) was, or will be, adopted by a water undertaker in accordance with an agreement to which new charging rules do not apply; and
- (b) in relation to a Sewerage Infrastructure Charge, if the premises are being connected to a public sewer that:
- (i) was provided by a sewerage undertaker under section 98 of the Water Industry Act 1991 and the charges for that public sewer were calculated on the basis of the provisions of the Water Industry Act 1991 before they were amended by the Water Act 2014; or
 - (ii) was, or will be, adopted by a sewerage undertaker in accordance with an agreement to which new charging rules do not apply.
- 16.3 In this paragraph “new charging rules” means rules about charges issued by the Water Services Regulation Authority under section 51CD or 105ZF of the Water Industry Act 1991.”