02 November 2017

Trust in water

New connections charges rules from April 2020 – England: Decision Document

Ofwat

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About this document

Water companies[1] must allow new connections to their networks. A major demand for new connections comes from new housing developments.

Water companies wholly or mainly in England ("water companies") must implement our charging rules related to new connections. These rules will apply to charges from 1 April 2018. We will consult and publish rules for companies wholly or mainly in Wales after the Welsh Government publishes their supplementary charging guidance to us.

Home builders (and ultimately end-customers) will benefit from a vibrant and competitive market for developers' services through lower prices, better and more innovative services. So we want to see incumbent water companies, Self Lay Organisations (SLOs) and New Appointments and Variations (NAVs) compete on a level playing field. A notable issue with the current approach to the new connection charges is that in most cases NAVs do not have access to a key discount is provided by water companies – the so-called 'income offset'. This puts them at a competitive disadvantage.

Therefore, we have concluded that the way the income offset is treated must change from 1 April 2020. In addition, we are introducing temporary arrangements to promote a level playing field from April 2018. We consulted ("July 2017 consultation") on our proposals in July 2017.

This document explains the final decision of the Water Services Regulation Authority (Ofwat) and how our rules will change. It affects **English water companies only**. The affected rules are:

- charging rules for new connection services; and
- charges scheme rules.

The actual changes to our charging rules and charges scheme rules will be made subsequently, but before April 2019, and separately from this document. In doing so,

[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.

consider drafting comments raised by stakeholders in response to our July 2017 consultation.

The following, previously published, documents may provide you with helpful background information:

- Our consultation on a new approach to connections charging for English water companies ("July 2016 document"); and
- our subsequent decision document ("December 2016 decision document").

In our July 2017 consultation we also put forward a proposal for a licence modification. Our decision and the stakeholders responses to that part of our consultation are dealt with separately in Modification to Instruments of Appointment for new connections charging. The actual changes to our charging rules and charges scheme rules will be made subsequently, but before April 2019, and separately from this document, taking stakeholders' responses to our July 2017 consultation into account.

Contents

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 with a number of benefits to developers[2] and end-customers. This can be achieved through a number of means:

- **Promoting effective competition for contestable services**. Clear, stable and cost-reflective tariffs can potentially facilitate efficient entry, especially when coupled with other measures.

- **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 that encourage developers to adopt technologies that redice water consumption.

- **Protecting the environment**. For example, charges provide an opportunity to improve the delivery of economic and social benefits such as environmental protection, where charges reflect the value of and potential impacts on the environment.

- **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.

[2] In this document we use the term "developers" to mean persons who want new or existing premises to be connected to a water company's water and/or waste water network.

- **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. In doing so we 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 December 2016 and updated our charging rules for new connection services in August 2017. These rules will apply to charges from 1 April 2018.

We want to ensure our rules remain up to date, fit for the future and are appropriately implemented. Therefore, in light of recent developments and the discussion in our previous documents, we have decided to address the issue of **how to treat the income offset**.

2. Overview of our proposals

This section summarises the proposals we consulted on in our July 2017 consultation and the main reasons behind our proposed solution.

Background

When a new development is built, there are two sets of infrastructure services provided to developers which are relevant to our decision:

- **On-site work**[3]. 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 third parties, such as the developers, SLOs and NAVs. 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 network reinforcement 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 whether 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, as a water company, receives in infrastructure charges to the incumbent water company.

On-site work is contestable and it is important that a levele playing field is maintained to ensure developers and end-customers obtain high quality, innovative and competitively priced services. If an incumbent water company undertakes the on-site work, there can be a discount in a water company's charge to developers, in the form of an 'income offset', for the provision of a sewer or water main whose original

[3] In this document, we use the term 'on-site' means on or in the immediate vicinity of a development. For the purposes of this document, laying a water main or a public sewer to a site is therefore classified as on-site work.

aim was to reflect, in part, the income that the incumbent water company would receive from the new development. To help level the playing field between incumbent water companies and SLOs, our rules also require water companies to ensure that any ‘asset payment’ payable to an SLO is of equivalent value to the income offset. Asset payments are payable to developers and SLOs who build mains or sewers that a water company adopts (although water companies are not required to make assets payments where they adopt sewers). The aim was to create a level playing field between developers, SLOs and water incumbents. Critically though, in the largest majority of cases currently incumbent water companies generally do not offer NAVs an equivalent discount. For example[4], they rarely adjust their bulk supply price or any other part of their bulk supply agreement[5] to account for the income offset or asset payment.

In our December 2016 decision document, we considered ways in which a level playing field could be created. We considered this could practically be achieved by offsetting any income offset against the infrastructure charge, rather than the requisition charge, and also said that we would consider consulting on this option and making a change to our rules in future. Our July 2017 consultation followed our considerations in December 2016.

Issues for water connections

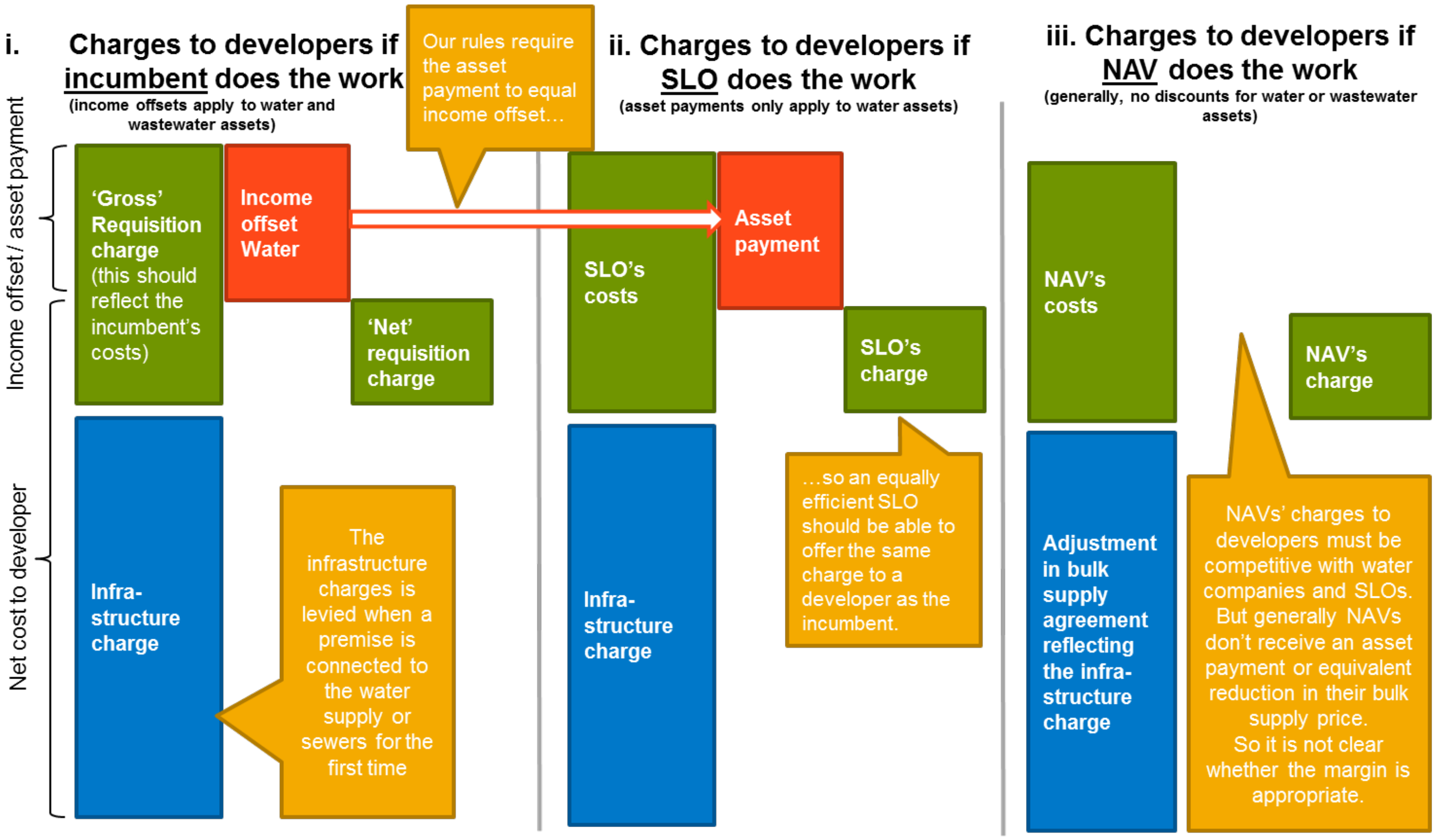
As we said in our July 2017 consultation, the way the income offset is treated gives rise to a number of concerns:

- **Distorting competition.** In the majority of cases 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 (Figure 1). This concern was noted in the FE review which was published together with our summary of findings and next steps.

[4] Anglian Water and Severn Trent Water offer NAVs an income offset for requisitionable costs through a discount to the bulk supply charges.

[5] 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. In this document when we refer to bulk supply agreements and/or charges we refer to both water and waste water services in the wider sense.

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



- **Fairness.** Currently the income offset can only be paid when (and to the extent that) a development requires on-site works, as it is linked to the requisition charge or asset payment. This means that those developments for which there is no requisition charge or asset payment do not receive an income offset. However, there is no inherent reason why this should be the case. Instead, we believe that if an income offset is to be provided by incumbent water companies it should benefits all developers.

- **Lack of transparency.** Currently, income offset/asset payments are not transparent. While most NAVs do not receive an income offset, for the few incumbent water companies that offer a discount to NAVs, this is done through their bulk supply agreements. This is not transparent. This lack of transparency fails to provide efficient price signals.

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

The options considered and our proposals

We considered the following options:

- **Option 1** – this is the status quo. We would not modify the charging rules we published in December 2016 (and have since updated in August 2017) that will apply to charges from 1 April 2018. Income offsets would continue to be set against the requisition charge or reflected in asset payments 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.

All options, except Option 1, would remove the need for asset payments (to be replaced by an income offset netted off against infrastructure charges).

We assessed these options against Option 1 to come to a view as to whether they: 1) promoted competition in the provision of on-site services; 2) provided clear signals that encourage efficient decision by developers; 3) had any unintended consequences; and 4) abided by good regulation principles.

In our July 2017 consultation we expressed a preference for Option 3. We argued that by setting the income offset against the infrastructure charge (and removing asset payments), incumbent water companies, SLOs and NAVs would be on a level playing field. We put forward that this was also more targeted, proportionate, transparent and predictable than the status quo. We also considered this approach reduced the regulatory cost by increasing clarity and reducing the likelihood of disputes. We argued that Option 3 by implementing changes from 1 April 2020 would avoid the temporary increases in end-customers' bills from 1 April 2018. At the same time, it would also achieve a level playing field as early as 1 April 2018, because incumbent water companies would provide to NAVs the same income offset discounts they provide to developers as part of any new bulk supply agreements from 1 April 2018 to 1 April 2020.

3. Our decision

3.1 Introduction

Having carefully considered all stakeholders' responses, we have concluded that Option 3 remains the most appropriate solution to the concern identified and that we should modify our rules accordingly in due time before 2020. However, in the light of the stakeholders' responses we consider that it is appropriate to slightly modify our approach to the temporary arrangement over the 2018-20 period and clarify our view regarding transitional arrangements.

This section is organised as follows:

- Section 3.2 summarises our decision including the minor modification to the temporary arrangement over the 2018-20 period. We also explain why we consider that this change is warranted;
- Section 3.3 discusses our view regarding transitional arrangements for this amendment to the new connection rules; and
- Section 3.4 picks up a few additional points raised by stakeholders for which we consider appropriate to provide some further clarity.

The responses to our July 2017 consultation and our consideration of these are discussed in detail in Annex A.1. Annex A.3 contains our final impact assessment. This is the impact assessment we published in the July 2017 consultation, as we have concluded that we should not modify it in light of the stakeholders' responses. The list of respondents to this consultation is set out in Annex A.2. As we are publishing all non-confidential responses alongside this document, we do not attempt to summarise them in detail in Annex A.1.

3.2 Our decision on the income offset

Although we concluded that we should adopt Option 3, we consider that it is appropriate to make a minor modification to our temporary regime covering the period 2018-20.

We believe that Option 3 creates a level playing field and effectively avoids the risk of undesirable increases in end-customers' bills. However, we consider that relative to Option 2a, which would implement the changes from April 2018, it did not perform as well in terms of transparency. This was due to the fact that the income offset would be included in bulk supply agreements for the 2018-20 period. We stated that to improve transparency this should be separately earmarked from the bulk supply charges to make it more transparent.

However, we are also mindful that a few incumbent water companies have already developed NAV specific bulk supply charges, which deduct the income offset in the form of an annualised discount on bulk supply charges. They were concerned that if they were to provide an income offset to NAVs as well against the infrastructure charge, this would result in a double payment and distort the level playing field for on-site competition. One company has already obtained assurance and Board approval for these charges.

We agree that in this case our proposed arrangement for 2018-20 would be burdensome and disproportionate. However, we also consider that including the income offset as an annualised value, instead of a one-off payment, is less transparent. In the light of this we have decided that over the 2018-20 period:

- those incumbent water companies that do not have a NAV specific bulk supply tariff by the date this document is published should offer the income offset to new NAVs as a one-off payment included in new bulk supply agreements with NAVs. This is what we proposed in our July 2017 consultation; however

- where by the date this document is published a company has a NAV specific bulk supply tariff in place and/or has obtained board approval for a new tariff to come into force by 1 April 2018, it:

    - does not need to amend its approved NAV tariff, as long as it can provide assurances that its treatment of the income offset leads to a value that is equivalent to the case when the payment would be one-off; but

    - it should also amend its NAV specific tariff to provide the income off-set as a one-off payment, as soon as possible at the next available opportunity – i.e. before April 2020.

In very rare cases a NAV may not need a bulk supply agreement because it does not require and purchase any bulk services from an incumbent water company (these

NAVs are sometimes referred to as “full service NAVs”). Some stakeholders have asked us to clarify the impact on full service NAVs. In these cases there would neither be a bulk supply agreement where the income offset could be reflected in the 2018-20 period, nor from April 2020 an infrastructure charge to net off the income offset. The latter is due to the fact that a full service NAV would not rely on the incumbent water company at all and the latter would not need to undertake any reinforcement costs. Hence, our approach would result in an income offset not being offered to these NAVs. We consider that in principle the transfer of an amount equivalent to an income offset to full service NAVs could be appropriate, as they may not be able to match an incumbent water company when competing to serve new development sites.

However, the absence of any agreement or other business arrangement between a full service NAV and the incumbent water company it replaced, would make this difficult. We are not aware of any current legal basis under the WA91 on which, in the absence of any agreement or other business arrangement, a water company could be required to make a payment to another water company. We consider that it would be dis-proportionate to explore how this could be achieved at this stage. This is because we understand that it will be extremely rare for a NAV would not to have a bulk supply arrangement. In addition, in the future it may be worth reconsidering the role of the income offset altogether (See discussion in Section 3.4.2). This may resolve this potential remaining concern.

3.3 Transitional Arrangements

Fair Water Connections (FWC) was concerned that transitioning to a new regime would create significant ‘market disturbance’ and two incumbent water companies asked for clarification regarding transitional arrangements. We consider that it would be helpful to clarify our position on these.

3.3.1. ‘Double discounts’

Infrastructure charges are paid at a later stage than requisition charges. There was a concern that this raised a risk that a developer could benefit from the income offset twice, if for a particular development the requisition charge happened to be paid before 1 April 2020 and the infrastructure charge after 1 April 2020.

Our charging rules give water companies flexibility about if and how they apply the income offset. This means they can chose not to apply an income offset if customers have already received it. Therefore, we do not need to change our rules to address this issue.

It would go against the general principle of 'fairness and affordability' for developers to receive a double discount in this way. Therefore, we expect water companies to use the flexibility afforded to them by our rules to address this issue.

3.3.2. Unpredictability of charges

There may also be a concern about the change to our charging rules for new connection services and (in relation to infrastructure charges) our charges scheme rules that will affect charges from 1 April 2020 for developments which would not yet have paid the requisition charge.

Where works have not been agreed, we expect, in accordance with the principle of 'stability and predictability', water companies to ensure customers have appropriate notice of the changes to their Charging Arrangements.

As our charging rules show, we think that developers should have the option of paying fixed upfront charges wherever reasonable. We want to be clear that, where a water company and a customer have agreed the charges, or the method of calculating them, they will be paid for specific work, we do not expect those agreed charges to be affected by any subsequent changes in the charging rules, including the one described in this document.

3.4. Further clarifications

Some stakeholders have raised specific points that we consider it would be helpful to clarify further. First, as there was some confusion, especially from developers, as to how our approach would work and its implications for stakeholders, we explain how we expect our approach to work relative to the current rules. Second, we put forward our considerations on a few alternative options that stakeholders put forward.

3.4.1. How the proposal would work in practice

Utilities Direct, House Builders Federation, Northumbrian Water explicit expressed concerns related to how our proposal would work in practice. In addition, many stakeholders - four incumbent companies, two NAVs, an SLO and a developer - sought clarifications.

An illustrative example could help to explain how our future rules (from April 2020) would work and how they would differ from the existing rules. Although the example is illustrative the data used is largely derived from data supplied by companies (i.e.

submitted as part of their Annual Performance Report) to make it more realistic. Table 1 shows our assumptions for an illustrative representative company.

Table 1: Assumptions for our illustrative example

Total value of the income offset	£500,000
Total connections in the period	2,000
of which requiring a requisition	1,200
Requisition charge (per connection)	£1,000
Infrastructure charge (per connection)	£500

Tables 2 and 3 examine outcomes for incumbent water companies and developers, respectively, under the current and the future rules (from April 2020). Table 2 shows that the incumbent water companies' overall revenues from new connections are unaffected by our change. This reflects the fact that the overall value of the income offset is netted off against the requisition charge under current rules and under the infrastructure charge under the future rules. The overall value of the income offset is, however, unchanged and so is the overall value of charges paid by developers.

Table 2: Revenues for incumbent water companies

	Current rules	Future rules
Gross revenues from requisition charges	£1,200,000 [(1)]	£1,200,000 [(1)]
Income offset	-£500,000	£0
Net revenues from requisition charges	**£700,000**	**£1,200,0000**
Gross revenues from infrastructure charges	£1,000,000 [(2)]	£1,000,000 [(2)]
Income offset	£0	-£500,000
Net revenues from infrastructure charges	**£1,000,000**	**£500,000**
Total Revenues	**£1,700,000**	**£1,700,0000**

[(1)] £1,200,000 from connections requiring requisitions (i.e. 1,200 x £1,000).
[(2)] Estimated as £600,000 from connections requiring requisitions (i.e. 1,200 x £500) and £400,000 from connections not requiring requisitions (i.e. 800 x £500).

Table 3 shows how the current and the future rules would impact on the average overall charges per connection. The difference is solely driven by how the income offset is treated under the current and future rules.

Under the current rules the income offset is only applied when the connection needs a requisition (or where self-laid infrastructure is adopted). In our example this means that the £500,000 overall amount for the income offset is applied in relation to 1,200 connections requiring requisitions (out of 2,000 overall). The income offset per connection therefore amounts to about £417 (i.e. £500,000 ÷ 1,200). Instead, those connections not requiring a requisition would not benefit from the income offset.

Under the future rules the income offset will be applied in relation to all connections (2,000), irrespective of whether a requisition was needed or not, resulting in a lower income offset per connection. In our illustrative example, this leads to an income offset of £250 (i.e. £500,000 ÷ 2,000).

As a result, under the future rules, connections requiring a requisition would be slightly worse off in terms of overall net charges for developers relative to the current rules (i.e. they will pay £1,250 vis-à-vis £1,083). Instead, those connections which do not require a requisition would be slightly better off (i.e. they will pay £250 vis-à-vis £500) relative to the current rules. On average though developers as a group will face the same charges under the current and future rules.

Table 3: Developers' overall charges per connection

	Current rules		**Future rules**	
Connections:	**requiring requisition**	**not requiring requisition**	**requiring requisition**	**not requiring requisition**
Requisition charges	£1,000	£0	£1,000	£0
Income offset	-£417	Na	Na	Na
Infrastructure charge	£500	£500	£500	£500
Income Offset	Na	Na	-£250	-£250
Total	£1,083	£500	£1,250	£250

In addition, the new rules envisage that the income offset should also be applied in relation to connections undertaken by NAVs. This means that the value of the income offset would be spread more widely to cover all developers irrespective of who they deal with (i.e. incumbent water companies, SLOs or NAVs). To continue our illustrative example, assume hypothetically that there are also 100 connections where NAVs are involved. These were not included in the previous illustration because (in most cases) they do not receive an income offset under the current rules. In Table 3 we assumed that under the new rules the overall amount of £500,000 was divided by 2,000 connections resulting in an £250 income offset per connection. Including the NAVs would spread the same amount over 2,100 connections resulting in a lower income offset of £238. This would make sure that all suppliers are on a level playing field.

3.4.2. Additional options proposed

Anglian Water, Severn Trent, Yorkshire Water and Albion Water also put forward alternative options on how to deal with the income offset which we had not considered in our July 2017 consultation. We briefly discuss two of these options for which we believe there is a benefit in clarifying our position (more detail on other suggestions are outlined in Annex A.1).

First, some incumbent water companies said that the income offset offered to NAVs should be based on their bulk supply price, rather than their retail price (which is currently used to inform the income offset). We do not agree. Although, from April 2018, incumbent water companies will have more freedom to set their income offsets, unless an equivalent income offset is made available to NAVs they will not be on a level playing field.

We also note that, contrary to the view of FWC, incumbent water companies do not necessarily differentiate retail charges between new and existing customers based on the costs they incur from connecting them. Incumbent water companies' allowed revenue for network costs is regulated through our wholesale revenue controls. The allowed revenue also does not vary with the numbers of new connections. This means the additional revenue from newly connected customers merely offsets revenue that would have been received from other customers anyway.

Second, the most radical suggestion was to eliminate the income offset altogether. In considering how to treat the income offset to level the playing field we have only considered options that retain the income offset.

While the income offset (together with asset payments) has featured in the regulatory framework for some time, we propose to revisit its role in the future. The income offset is effectively a payment from existing end-customers of an incumbent water company to either end-customers of new developments, developers and/or land owners.

In principle, there are some arguments as to why there may be benefits if existing end-customers share costs of expanding the water network for new developments. For instance, there may be some economies of scale, meaning that the average cost of supplying water and waste water services per connection may decline with new developments. Hence, existing end-customers may benefit from lower costs and should pass on some of their benefits to the end-customers of new developments. However, the scope and materiality of these economies of scale is unclear. In addition, any benefit would be spread across all end-customers at each price review anyway, reducing the need for an income offset.

Given the above and the fact that the income offset, even when reformed in April 2020, adds to the complexity of new developments' charges, we consider that in the future there may be scope for further simplifying the regulatory framework for new connections. We would consider how this fits with Defra's current guidance – in particular, we are mindful to ensure that the current balance of charges between customers and developers is broadly maintained - and would work with Defra as appropriate.

4. Next Steps

We plan to publish updated charging rules before April 2019 to give effect to this decision. We have decided not to publish the change now, because:

- the change will take effect in relation to charges payable from April 2020, so we do not need to make the change now;
- publishing two sets of rules (‘April 2018-2020 rules’ and ‘April 2020 onwards rules’) simultaneously for an extended period of time may create unnecessary confusion; and
- maintaining two sets of sets of rules will add to our administrative burden, because if we any other changes to the rules are needed before April 2020 we would need to change both sets of rules.

However, we recognise that stakeholders will need some lead time, so they can understand what rules will apply from April 2020. Hence, our intention is to publish the ‘April 2020 onwards rules’ before April 2019.

A1 – Summary of consultation responses

This Annex provides an overview of the stakeholders' responses to Questions 1 and 2 in the July 2017 consultation. However, we have also covered stakeholders' comments included in their responses to other questions when relevant to the treatment of the income offset. Stakeholders' responses related to the licence modification (Question 4) have been addressed in the Modification to Instruments of Appointment for new connections charging. Responses to our draft charging rules and charges scheme rules (Question 3) will be taken into account when we publish them before April 2019.

This Annex provides:

- a high-level overview of stakeholders' responses; and
- a more detailed description of key relevant issues raised by stakeholders and our responses.

High level overview of stakeholders' responses

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?

Under Option 3, the income offset would be included in any new bulk supply agreements between NAVs and incumbent water companies over the 2018-2020 period. From 2020, incumbent water companies will provide an income offset to all customers including NAVs. The income offset would be netted off the infrastructure charge and asset payments would be removed and replaced by an identical income offset.

We received responses from 24 stakeholders: 11 respondents (consisting of half of the incumbent water companies and all NAVs which responded) agreed with Option 3 and 13 disagreed. The majority of respondents provided reasoning and 3 stakeholders provided some evidence.

Of those who disagreed, all SLOs and developers indicated a preference for either the status quo or Option 2a. Half of the NAVs, who responded, preferred Option 2a as they claimed it would level the playing field quickly and avoid the perceived risk that incumbent water companies might set the income offset against the bulk supply charge in an anti-competitive way. The companies who disagreed with Option 3 were split between arguing that timescales are too tight or disagreeing in principle.

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?

We received responses to Question 2 from 17 stakeholders. Only some responses stated if they agreed. The majority argued that more details could be provided and some argued that the draft impact assessment did not include detailed costs. No-one provided quantitative evidence to support their arguments.

Q3. We also asked stakeholders if they had any comments on the drafting of possible future changes to the Ofwat Charging Rules

We received 25 responses to this questions although only 13 respondents provided substantive comments. Twenty respondents seemed to agree with the proposed drafting with minor or no alteration or gave no comment at all on the proposed drafting. Five respondents, all NAVs or SLOs refused to provide comments as they disagreed with the proposal to choose Option 3.

A1.1 The main issues raised by stakeholders

We have grouped relevant stakeholders' concerns under the broad categories below. We have grouped together similar, but not necessarily identical, comments and arguments by different stakeholders under some headings. Some of the concerns raised by stakeholders have been dealt with in more detail in the main text. Hence, these are not mentioned in this Annex.

Stakeholder response		Our view
Costs and benefits included in the impact assessment	The impact assessment is insufficiently detailed.	We have not included more detailed cost estimates. We qualitatively described expected costs suggested by stakeholders under our "good regulation" criterion. Trying to quantify relative costs under each option would be imprecise and disproportionate.
	We should consider implementation and transitional costs for incumbent water companies in developing new charges.	We do not consider that a quantitative estimate of these costs would change our decision. In addition, we did not receive any quantitative evidence from stakeholders, hence we have retained our qualitative assessment in Annex 3. The cost of adopting Option 3 is de minimis relative to the status quo due to the long period of time incumbent water companies have to implement the change. Option 2a would have higher costs and Option 2b has very similar costs to Option 3.
	We should consider loss of transparency. For example, putting the income offset against the infrastructure charge is not transparent because the income offset is not related to off-site costs.	We disagree because the income offset is not necessarily related to types of activities or costs (See Section 3.4).
	We should consider tax and RCV impacts.	We did not receive quantitative evidence from stakeholders, but we consider the impact on companies' RCV to be negligible because new connections assets are a very small proportion of companies' total asset base. For the same reason, we do not foresee tax costs to be significant and in addition, companies have flexibility over how they account for requisition costs.
Distributional impacts	We should consider the impact of the options on developers and their cash flows as the requisition charge is paid before the infrastructure charge.	In terms of cash flow, we recognise moving the income offset from the requisition charge to the infrastructure charge may in principle have a small impact due to the fact that it may be paid at a later stage. It is important to reiterate that incumbent water companies need to maintain the broad balance of revenues between developers and end-customers. Hence, any impact

		should be substantially mitigated by this. We also not that the changes that will come into force on April 2018 will have an opposite effect as requisition charges will fall relative to infrastructure charges.
	We should consider the impact on new customers.	We do not understand the relevance of this comment. In Section 3, we argue that shifting the payment of the income offset to the infrastructure charge does not change the overall revenue incumbent water companies raise from developers. They must maintain the broad balance of revenues between end-users and developers.
	Some SLOs and developers would want to know if they would continue to pay bonds if asset payments are removed.	We have not considered this issue as we did not receive any evidence from stakeholders. In addition, bonds paid by SLOs to incumbents as surety or effect liability retention payments are outside the scope of our charging rules. SLOs and incumbent companies need to agree the arrangements of bonds as part of the terms and conditions for their adoption agreements. We have set out our expectations in Assurance terms in self-lay agreements entered into under section 51A of the Water Industry Act 1991.
Comments specific to Option 3	When assessing Option 3, the impact assessment implicitly assumes that NAVs are the only competitors to incumbent water companies. Instead SLOs already provide all or most benefits of competition.	We agree that SLOs provide significant benefits by competing with incumbent companies. However, a level playing field would allow NAVs to provide further benefits to developers and in addition extend these benefits to end-users.
	Option 3 provides a temporary subsidy to NAVs, it is a short period of time so only a few companies will benefit from this subsidy. The logic of this approach is based on the	We disagree as all on-site competitors will receive an equivalent income offset which will mean they are on a level playing field. The income offset also only applies to new NAVs and not existing NAVs.

	fact that bulk supply agreements are outside the price control.	
	Option 3 is a complex regime which increase administration costs, as it requires two sets of transition arrangements.	We cover transition arrangements in Section 3. We do not need to introduce a prescriptive, transitional process as it was put in place for the introduction of our charging rules from April 2018. We do not expect significant administrative implementation costs.
	Option 3 would lead to disputes. For example variations in calculations of the income offset around timing and volume could create differences between NAV and SLO discounts.	We do not expect issues to arise as companies must adhere to our charging rules which ensure charges are transparent and a level playing field for competition. Section 3 also explains the transitional arrangements and makes clarifications.
	Option 3 could compromise trust and confidence in the sector.	We do not understand why a change that will level the playing field without leading to bills' increases for end-customers should have such an effect.
	Option 3 dulls price signals to developers and NAVs.	As discussed in our July 2017 consultation we believe that moving the income offset against the infrastructure charge means requisition charges may provide better price signals to developers irrespective of the option chosen relative to the status quo. We also argued that 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.
Alternative options	The income offset should be based on NAVs' bulk supply price.	We explain in Section 3 why we do not considered this is appropriate.
	We should treat the income offset as a separate reward, paid from the incumbent to whoever builds the on-site assets. It could be	We do not consider this option as it is only a presentational change which companies can address by setting out their charging arrangements in a

	paid alongside the infrastructure charge, but remain separate.	transparent way. It is also not possible under our legal powers to require companies set new charges for developers.[6]
	Maintain the current arrangements, but apply the income offset to NAVs' bulk supply charge as a permanent, rather than just a short term solution.	We do not consider this option (i.e. the temporary arrangements for the 2018-20 period under Option 3 made permanent) as it is less transparent than Option 3.
Additional observations	We should show the cost differences between NAVs and incumbents to show why NAVs find it hard to compete.	We consider this irrelevant. NAVs should be able to compete if they are more efficient or provide better quality service than incumbents (and SLOs). By changing the way in which we treat the income offset, we aim at removing a factor that contributes to the current unlevelled playing field.

[6] Our powers to making charging rules in relation to requisitions (section 144ZA of WIA91) or in relation to end-user charging schemes (section 143B of the WIA91) do not give us the power to make rules that would require water companies to make payments to customers.

A2 – List of respondents to our consultation

New Appointees and Variations
Albion Water
Icosa Water
Independent Water Networks
SSE
Veolia Water Projects

Self Lay Organisations
Fair Water Connections
PDI Utilities
PN Daly
Utilities Direct

Water and sewerage companies
Anglian Water
Northumbrian Water
Severn Trent Water
Southern Water
South West Water
Thames Water
United Utilities
Wessex Water
Yorkshire Water

Water only companies
Affinity Water
Bristol Water
Portsmouth Water
South Staffordshire and Cambridge Water

Developers
House Builders Association
House Builders Federation

Other
Consumer Council for Water
Waterwise
Water UK

A3 - Impact Assessment

1.1 Outcome

We have not made any changes to the impact assessment below but have included it for ease of reference.

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 2016[7]

Who undertakes on-site works	Discount	What developers pay

[7] 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.

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 = (gross 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[8])

[8] 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.[9]

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.

[9] 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;10 and
- Capital costs would decline because assets 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.[11] 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-

[10] 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.

[11] 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 then £10,000 for household customers or £25,000 for non-household customers.[12] 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:

[12] 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.[13] 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.

[13] 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 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.

A4: 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. The 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.*