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Dear Ofwat

Re: A consultation on the scope and balance of developer charges and incentives

Thank you for the opportunity to comment on this consultation. We recognise that the Developer Services market covers a range of market activities, with major new sites, off-site reinforcement for a range of developers, Self Lay arrangements, wholesale bulk supply connections to NAVs and activities for existing householders such as supply pipe separation and communication pipes for small developments. Even with major new connections, it is possible to make a distinction between commercial activities and those where there is a wider social need for the new infrastructure, such as resolving historic private water supply system issues.

In our view, the consultation fails to consider these different market segments adequately before arriving at solutions. There also appears to be a lack of "corporate memory" of the justification for the current arrangements, which have only been in place since April 2020. In combination, this does not lead to a set of proposals that goes beyond some economic theory to what different developer stakeholders might see as the impact of further changes. The current developer market arrangements followed a period of extensive consensus building by Ofwat and the water sector, not that long ago. We would also observe that the balance of charges between different customer groups is a matter for DEFRA's charges statutory guidance, and it is not clear from the consultation whether DEFRA support the implications of the changes Ofwat are consulting on, which is necessary to allow stakeholders adequate context in order to provide a response.

Whilst the question of who should pay for new developments is important, there is unlikely to be a definitive answer that is socially beneficial. It is normal to consider what social or consumer detriment currently exists for such allocative questions. In this case we have a group of developers or their agents operating as businesses within a competitive market, who should be expected to incur a reasonable element of the cost, recouped through the margin which they are able to obtain on the sale of new properties. However, the distinction made in the consultation between customers of developers buying properties and their on-

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going payments through water charges, is only really relevant where there are resource allocation and location questions to resolve. The consultation recognises this with the potential for zonal infrastructure charges, but this is something that is already possible where appropriate in the current framework. So what is the issue Ofwat are trying to resolve?

Water supply is not going to be a deciding factor in the choice of where developers build properties or influence consumer decisions of where to move into them. The focus on efficiency incentives in the consultation can be used by companies to some degree, but Ofwat should not expect this apply to all areas of the country where there are not zonal or infrastructure costs saved for specific developments based on volume of capacity of the infrastructure required. Infrastructure reinforcement has to anticipate peaks, rather than average use to avoid risk to existing customers at those peak times. Development incentives would follow peak pricing for existing customers if this was socially or economically beneficial, which is not the case for domestic and most business consumers of water services.

There are alternative considerations if the logic we set out above is followed. As income offset reflects that developers are paying infrastructure charges for network reinforcement, but this also benefits existing customers in terms of resilience and capacity, there could be a logic in applying income offset to brownfield rather than greenfield developments, or to apply a larger share to smaller developments (e.g. a larger value to the first 5 properties), or to incentivise social development markets (e.g. reallocate to subsidise remote or private supply connections). This could include community assets, including both SUDS and rainwater harvesting for local ecology schemes.

We are concerned by the proposal within this consultation to discontinue the income offset payments, which have only been in operation for a year. In our view the rationale for their introduction was justified, and their removal without a replacement of similar value (or to achieve a specific purpose as described above) would cause significant levels of dissatisfaction for developers and SLPs, as it would result in large increases in the charges they are required to pay. This would particularly disproportionately impact smaller or private housebuilders. The justification is not explained in the consultation or the Frontier Economics report, so we think it is important to set this out here.

The move to income offset from requisition discounts and asset payments was market driven, to allow for more effective competition for NAVs compared to both SLPs and non-SLP sites. For the water service, this reflected a transition away from nationally set infrastructure charges, but where all large developers (NAVs, SLPs and non-SLP sites) had to pay for specific offsite infrastructure to connect the developer. Recognising that this infrastructure that specific developers (and their customers were paying for) could distort the housing market and result in disputes because this new infrastructure also provided

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resilience for existing customers and future customers of other developments, payments for the requisitioning of on-site mains was mitigated by the future income from that customer – the developer paid up front for the off-site specific network reinforcement, a generic infrastructure charge for wider network reinforcement, and on-site only to the point that there were sufficient new properties contributing for their water bills.

Income offset shifted how this recognition of contribution to off-site network reinforcement benefits to existing customers in terms of resilience. It happened together with a new approach to infrastructure charges, so these specifically were linked to the network infrastructure reinforcement. It moved the recognition of the contribution customers make in their bills to past reinforcement and its maintenance from the on-site costs (to make on-site markets of SLPs and NAVs more transparent and to work better), with less disputes on off-site reinforcement allocation between maintenance, general growth and development specific costs, that had previously delayed developments (and could hinder economic growth), and to be fairer across developments both large and small. Balance of charges rules between developers and other customers were a simple proxy for this, which was another competitive market development need and request of developers.

Other alternatives for infrastructure charges other than a fixed "entry fee" for each area were considered, but Ofwat rejected them in favour of simplicity, only now to suggest them again without really considering the previous consultations. At the time this included the current consultation suggestion (oddly now described as for "rural" areas) as a balance of distance and number of connections. These were rejected on the grounds of complexity and lack of certainty for developers, alongside unfairness of only focusing on the network cost, when water resources are generally sourced from rural areas, with the transfer back to rural areas generally reflecting the economics of water treatment nearer to population centres. Who is benefitting from cross subsidies appears to be a matter of judgement?

The above logic largely applies to the water service. For wastewater a different logic for the economics of the value chain is likely to apply (as it did historically for requisitions) which means that a different conclusion could be reached on income offset. The consultation did not explore this, but for income offset we believe it has a rationale, which has not changed since it was introduced, and should not be amended without a clearer reason of a market problem that would be improved. As it stands, we see disadvantages, particularly for the individual property. We considered whether Ofwat could define a threshold that would allow for a distinction on cost reflectivity to be made, but we concluded this would be arbitrary and might prevent SLP market development.

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We agree that developers should not be required to fund strategic assets[1], as in practice it is difficult to separate the need from these for new developments from that which would be required for population growth within the existing property base.

We would disagree with any suggestion of introducing mandatory variable charges for different regions within a company supply area. Bristol Water is operated as a single water resource zone and has sufficient resilience of utilisation of treated water into distribution so any proposals would not be justified in our area in any case, as the resource needs of a particular area can be contributed to from many of our existing 'strategic' treatment and water resource assets.

We note the suggestion that water efficiency incentives could provide an equivalent alternative discount to the income offset payments. Given the scale of income offset payments we currently apply, such incentives would need to be significant to match this value. We are not yet aware of an incentive scheme which would have the required effect on developers, and are wary of unintended consequences, for example of water efficient fittings being included just to obtain the discount, that are then removed by the end customers when they move in, over which there is no control. We continue to explore with developers what type of scheme may remove this risk (which again is limited to the water service), and do not believe that it changes what can currently be achieved with infrastructure charge discounts if they are justified.

We provide fuller answers to each of the consultation questions below.

Q1: Do you have any comments on key conclusions from the Frontier Economics report?

The Frontier Economics report is well written and explains clearly the current arrangements for connection charge payments.

The key conclusions, and our views on them can be summarised as:

1) Income offset payments should be discontinued as it is not clear that there is an economic rationale for developers paying less than the full cost of connecting new developments – we disagree. It has an economic and policy rationale. Whilst other rationales can be considered (including cost reflectivity), the report errs in not reflect the rationale that existed when it was created, which was not just maintaining a balance of charges from a previous transition.
2) it is appropriate for developers to contribute to the additional costs required to serve the new developments over and above the existing customer requirements –

[1] ie upstream of treatment works, as the term strategic is confusing given that strategic mains that distribute treated water from a works might need to be reinforced because of a development, and this is currently within the scope of network reinforcement that developers pay for.

including offsite costs – we agree (where the costs can be accurately and fairly attributed to new developments, and where the social and economic benefits overall are supported by this cost allocation)

3) It would be more cost reflective if developer charges were higher in areas within company supply areas where network reinforcement costs are higher, and charges lower where costs are lower – we agree where it is clear this is the case over time and this is a persistent situation that an area has a higher cost to serve, but we disagree that this applies in general.
4) Use of environmental incentives should be expanded, to promote water efficiency and sustainable drainage systems – we do not object but note that this does not compensate for the removal of income offset, because that was not the rationale for income offset – it is the rationale for a discount / allocation approach to infrastructure charges. Otherwise, you would reflect such incentives in water prices, not income offset, to have a greater impact. Incentivising developers rather than addressing ongoing consumption is not likely to be socially optimal.
5) Frontier recognises that moving to a more cost reflective approach would increase complexity of charges and would increase cost of implementation – we agree – this was why income offset was developed.

We disagree with Frontier's key recommendation of removal of income offset payments. We have several reasons for disagreeing with this recommendation:

1) We do not believe the current system has had sufficient chance to be tested and applied in practice. We suggest that as a minimum it is retained for the remainder of this AMP before a decision is reached on replacing it. This would also allow for greater time for engagement with developers on potential alternatives and the implications for charges. Unless of course there is a strong view from the wide range of different "developers" that the market would benefit from alternative arrangements that would deliver the outcomes described in the consultation.
2) Removing income offset payments would cause a significant increase in developer charges, which would not necessarily be compensated through introduction of environmental incentives. The current system serves to maintain a level of balance in charges that appears to be broadly acceptable to a wide range of customers and developers, and as such we should be mindful of the impact that any change to that balance would bring.
3) Many of those who are paying developer charges and benefitting from income offset are also existing customers. The impact of any change to the level of developer charges may be particularly harmful to small and private housebuilders.
4) Income offset has a role in recognising that infrastructure reinforcement also benefits existing customers through providing additional resilience to their supplies. So whilst we do agree with the principle of cost causation, the benefits delivered by construction of new developments should also be considered within this calculation.

The consultation does not recognise the benefits of connecting private water supplies. Infrastructure charges are applied to all developments, big and small, so for example are applied to lower level activity such as separation of supply pipes or connection of a "granny flat" to an existing supply. Income offset helps to ensure small single developments do not overpay for connections compared to the scale of big developments. Further, such small supplies are less likely to be impacted by the competitive SLP market which may otherwise help to reduce costs.

There is therefore a social aspect to this aspect of the charging framework, which could be undone if discounts were removed. Whilst rules could distinguish between size of site, considering the number of connections, this may cause unwanted incentives around the threshold, at whatever level it is set. There is a question of the social concerns – differing levels of income offset can be a rationale for where houses are built. However, the point that some "developers" then inhabit the new houses that they build is not then picked up in the report.

We also have concerns about the potential removal of income offset payment on the nascent NAV market, as generally income offset is available to NAVs, and so removing it could lead to an increase in charges to NAVs. NAVs are the main focus for building water efficiency properties given their ongoing role on the site, and incentives to support customers in doing so. Given this, the consultation proposals could have the opposite impact to those intended. NAV respondents will be best placed to express a view on this point.

The table in figure 3 in the Frontier report implies that income offset is linked to offsite local assets, as it includes income offset within the cost recovery column for reinforcement of offsite local assets.

We do not believe that Frontier are correct to include increasing capacity at treatment works as one of the costs involved in new developments. Generally, there is spare capacity within existing works and it would be inaccurate in most circumstances to attribute treatment works growth to specific new developments, or new developments in general. We could not identify a specific example within the experience across the sector of those we discussed this with at Bristol Water, where we identified that a new development could be attributed to a cost of building or upgrading a **water** treatment works. There were many examples related to wastewater treatment works in small rural locations, but this typically was driven by quality requirements and supported a wider need as well as the development in a local plan.

Q2: We seek views on our reasoning and proposals with respect to charges for strategic assets, income offset and the balance of charges rule

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We disagree with removing the balance of charge rule, without also revisiting the significant changes in charge rules. The two should be considered together, as at present the balance of charges serves to maintain a degree of stability in charges, so its removal could lead to greater fluctuations in the calculated charges for each year. We do not believe this would be welcomed by developers and may have unintended consequences for timings of applications and levying of charges, which suggests the balance of charges should be maintained.

We think that the introduction of the balance of charges rules was Government policy driven. The DEFRA statutory guidance would therefore also need to be amended in order to change the balance of charge rules. Whilst Ofwat can propose changes in this guidance, it is for DEFRA to consult on this, and we were not clear on the policy imperative from this consultation that necessitated such a guidance change.

Income offset is not in itself the only route to maintaining balance of charges, it is simply the most recent interpretation of the rule. Any change will affect small developers disproportionately compared to big developers, and as most developments are relatively small, this will require significant stakeholder management in the run-up to these changes being implemented. First this needs a clear policy direction and justification so that developers can see the benefits from what amounts to a significant increase in charges, however you look at it.

Q3: What environmental incentives should water companies be offering developers and NAVs? We are interested in examples of good practice. How can we better support this?

The consultation proposes implementing this from 2022/23. However, such incentives are possible now, where there is a good justification (which we continue to work with developers to identify). We do not see that there is a good justification for setting any date at this stage when the change is not clear.

Whilst we are considering what environmental incentives might be appropriate, and we note that their introduction is not necessarily contingent on the removal of income offset payments, we do not believe these can replace income offset which is tackling a different issue (small vs large developments), and they would need to be at a large scale to replicate the financial impact of income offset payments. This is unlikely to be practically achievable, particularly for smaller scale developments.

An incentive to provide more water efficient fittings already exists on developers through Part G of the building regulations:

Paragraph 36(2)a and b of Part G states that a maximum water usage figure of 125 litres per person per day must be achieved, with an option for the planning authority to apply a *reduced target of 110 litres per person per day as part of the planning application. Further more a Part G required a water efficiency calculation is completed and submitted to the relevant Building Control Authority at design and as-built stages. Failure to comply with the target water use figure will adversely affect the SAP rating of a newly created dwelling.*

However, we should be mindful that developers can only influence Per Capita Consumption through the fittings provided within properties, and much is dependent on the behaviour of the occupants, which is beyond the control of Developers. Changes in consumption patterns resulting from increased home-working during Covid-19 may be expected to persist to some extent in future, and so targets may need to reassessed because of that.

The consultation is not clear on the differences between how new developments impact water and wastewater networks. This is relevant because the greater proportion of environmental incentives would apply to wastewater charges. For example, sustainable drainage systems do not apply to water only companies so we could not offer an incentive for their provision, or the removal of surface water drainage charges to customers. This may further hinder water-only companies' ability to compensate for the removal of income offset payments through incentives.

Water scarce zones or capacity constraints would not apply to all companies, due to differing water resources positions across the country. However, we can see some case for part of income offset being linked to the construction of water efficient homes (perhaps in developments above a certain size where there is no offsetting social benefit such as resolving private water supply issues), and we would potentially support the retrofitting of water efficient fittings to smaller properties. This is currently covered through the ability to vary infrastructure charges, so does not provide a new potential means of improving water efficiency. The distinction should be between cost reflectivity in infrastructure charges (ie where the development is avoiding network reinforcement), and the general contribution to water efficiency. Different zonal infrastructure charges are already possible, but we do not consider it appropriate to apply them within Bristol Water that operates as a single water resource zone with operational resilience between multiple treatment works and network components, as well as water resources.

The principle of "sharper" price signals assumes that price signals will make a difference to development choices, otherwise they just become a form of "tax". Ultimately developers are driven by the market (delivering what consumers want), planning (doing what authorities require) and the cost of construction (including timing of getting to market). Changes in infrastructure charges will make little impact to the overall cost to developers of most developments, compared to local planning and market requirements. There is a question though of whether a social aspect (eg connecting private supplies) could be a focus for the balance of charges, or whether we should also seek to incentivise community schemes that

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improve the environment or community water efficiency when a development adjoins an existing community.

We do not agree that there would be logic in offering a greater income offset in areas where there is greater capacity on the network, as infrastructure charges are already set to be cost reflective, so it is not clear what the additional income offset in these situations would be balancing? Where areas do have greater capacity that reflects past investment in the network, so it is not clear to us that this should be a basis for providing additional incentives to developers. We also do not see clear zonal boundaries which would justify differential pricing in infrastructure charges, at least within our own area, so any attempt to introduce this would be more likely to reduce than increase cost-reflectivity. The case in wastewater with smaller discrete catchments than the water service may be different, and there is less original rationale for income offset, with infrastructure capacity often driven by surface water drainage which should be avoided from sewer design for significant developments but would be less practical for smaller sites. The market definition needs to be clearer in the consultation to identify the solution for reasons such as this.

The concept of charging more for connections or developments in more remote locations does not reflect the public service aspect of water service, as the consultation only sees new developments as a market opportunity. We do not think it is reasonable to discriminate against those communities which happen to be located further from our own strategic assets. We see ensuring that private water supplies can connect to our network at a reasonable cost is a matter of social benefit, equivalent to the provision of rural broadband for instance. Equally, we recognise that there may be public interest in encouraging brownfield developments, rather than greenfield developments. This affects decisions on average infrastructure charges but may be something that could be reflected in the income offset, potentially reflecting past contributions and the challenges of retrofitting.

We think that as well as considering environmental incentives we should also consider what social incentives could be applied. This may help to balance the impact on more rural and remote locations if income offset was removed. It may also help to address the issue of private supplies – a set of individual properties that (in places due to a historic arrangement not being maintained or abandoned by the landlord) would see a social benefit from a new connection but may not be able to afford to do so if they have to bear the cost in full, in which case the income offset is a loan from the future contributions to maintaining the wider network which those residents currently do not benefit from.

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We hope you find these comments useful, please let us know if you would like to discuss any of them further with us.

Yours sincerely

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Director of Strategy & Regulation

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