October 2021

Scope and balance of developer charges and incentives – conclusions

Ofwat

About this document

This document summarises the responses we received to our April consultation on the scope and balance of developer charges and incentives and sets out our conclusions. We have published responses on our website.

We want charges that support the ambitions of our strategy. Charges should be cost-reflective, transparent and fair, across the whole range of water companies' customers. Charges should support markets, thereby facilitating greater choice of services. Charges should be doing more to tackle long-term challenges of the water sector, in particular by providing incentives for developers and third parties to build water efficient new homes and sites with sustainable drainage.

This document forms part of a wider programme of work on charges for and regulation of developer services, including how we regulate developer services through our 2024 price review (PR24).

We will continue to work with the water sector, including developers and third parties, to improve charges and strengthen environmental incentives.

1. Summary

1.1 Our April consultation

Our April consultation examined the structure and scope of charges for developer services, with a particular focus on the balance of costs recovered from developers and other customers (**the balance of charges**) and incentives for better water-sector outcomes for the environment and society (**environmental incentives**).

We also published [a report prepared by Frontier Economics] on the balance of charges that developers and other customers pay to cover the costs of new developments (**Frontier report**).

There are separate developer services (or new connections) charging regimes for English companies and for Welsh companies. We consulted on issues of relevance to both. We are undertaking a separate process to develop new connection charging rules for Welsh companies, and hence did not make specific proposals for Welsh companies. More details are in our [July decision document on new connections charging rules for Welsh companies].

With respect to English companies, we proposed, as part of our wider work to improve the cost-reflectivity and transparency of new connection charges, to:

- retain the current framework that developers do not contribute to the costs for strategic assets (except in the form of environmental incentives).
- continue to allow companies to set simple, highly-averaged infrastructure charges for most developments, but considered whether a requirement to have bespoke infrastructure charges in the most remote locations might be beneficial.
- remove the rule, from 2025, to maintain at pre-2018 levels the balance of charges that developers and other customers pay to cover the costs of new development (**the balance of charges rule**) and any income offset discount.

We received comments from 28 stakeholders on our proposals and on the key conclusions in the Frontier report.

1.2 Our conclusions

We want charges that support the ambitions of our strategy, including tackling the long-term challenges facing the water sector. In particular, we want:

- charges that reflect costs, supporting fairness and affordability across companies' different sets of customers;

- charges that are transparent, benefit customers and, by supporting markets, offer developers greater choice; and
- companies to play their part in giving incentives to developers and third parties to build water efficient new homes and sites with sustainable drainage.

We are grateful to all respondents for their insightful views and challenges. We have considered these carefully in deciding how to proceed, and have concluded that for new connection charging for English companies we will:

- undertake and publish **a review of water companies' approaches** to setting, communicating and engaging on **environmental incentives** for 2022-23, highlighting good and poor practice, to strengthen their use and effectiveness; this will also inform how environmental incentives should be regulated from April 2025;
- from April 2025, disallow English companies to offer **income offset**; we conclude that there is no convincing justification for income offset, and that any discount or surcharge reflecting environmental or social issues should have a clear rationale;
- give further consideration to **how to implement** these changes, considering the balance between issues such as bill stability and regulatory complexity; and
- from April 2025, remove the **balance of charges rule**; this forms part of our work to make new connection charges more cost-reflective, so that end customers do not fund companies' costs that are incurred as a consequence of new developments or vice versa.

In addition, for English companies, we confirm that we will retain the current arrangement that developers do not contribute to the costs of **strategic assets**, except where they take the form of environmental incentives. We will not introduce a new requirement in the charging rules for bespoke **infrastructure charges** for more remote developments; we will retain the current flexibility in charging rules that allows, but does not oblige, companies to vary infrastructure charges by location.

We have made these decisions seeking to balance the interests of developers and other customers, support markets to the benefit of customers, and support water companies to work with developers and other stakeholders to address the water sector's long-term challenges. We look forward to collaborating with all stakeholders on these important issues.

1.3 Structure of this document

The rest of this document is structured as follows:

- In chapter 2 we summarise responses to our April consultation and set out our decisions on the changes we proposed.
- In chapter 3 we provide more detail about our wider work to support the developer services market.

- In Appendix 1 we assess the scale of income offset against other relevant factors.

2. Consultation responses

2.1 Our April consultation

Our April consultation examined the structure and scope of charges for developer services, with a particular focus on the balance of costs recovered from developers and other customers (**the balance of charges**) and incentives for better outcomes for the environment and society (**environmental incentives**).

We also published a report prepared by Frontier Economics on the balance of charges that developers and other customers pay to cover the costs of a new development (**Frontier report**). Frontier Economics concluded that

- It would be more cost-reflective and in line with the principle of cost causation if developers paid for all off-site costs that are incurred as a consequence of new developments.
- The economic rationale for a key industry discount, income offset, is weak.
- Alternative approaches to charges and charging structures could do more in promoting social and environmental incentives.

In our consultation we proposed:

- to retain the current framework that developers do not contribute to the costs for strategic assets (except in the form of environmental incentives);
- to continue to allow companies to set simple, highly-averaged infrastructure charges for most developments, but considered whether differential infrastructure charges in the most remote locations might be beneficial; and
- to remove the ability to offer income offset for English companies from April 2025 onwards, and remove the balance of charges rule at the same time.

We asked for comments on the key conclusions from the Frontier Report and on our reasoning and proposals with respect to charges for strategic assets, income offset and the balance of charges rule. We also asked how we could better support environmental incentives for developers and NAVs.

2.2 Summary of responses

We received 28 responses to our consultation and we thank all respondents for their input. We include a full list of respondents in Table 1 and have published responses on our website.

Table 1 – Respondents to our April consultation

Water and wastewater companies		New Appointees, SLPs and developers[1]	Other respondents
Affinity Water Anglian Water Bristol Water Northumbrian Water Portsmouth Water Severn Trent Southern Water South East Water	South Staffordshire and Cambridge Water South West Water Sutton and East Surrey Water Thames Water United Utilities Welsh Water Wessex Water Yorkshire Water	Barratt Homes Independent Water Networks Limited (IWNL) Last Mile Asset Management (LMAM) Persimmon Homes PN Daly Vistry Group	Consumer Council for Water (CCW) Fair Water Connections (FWC) Skewb Technical Design Services (TDS) WA Consultancy Waterwise

Respondents gave us a range of views on the questions we asked. For example, there was strong, cross-sector support for retaining the current approach to charging for strategic assets, but a more mixed response to the proposal to remove income offset and the balance of charges rule.

In the rest of this section, we summarise consultation responses for each proposal, and explain how we intend to proceed. Where respondents make the same comments in relation to more than one question, for simplicity we do not repeat them.

2.3 Responses to Question 1

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

[1] A new appointee is a company that has been granted an appointment by Ofwat to become the statutory provider of water and / or sewerage services for a geographic area, replacing the existing water or sewerage appointee. Companies without an existing appointment become new appointees; those with existing appointments have theirs varied. Hence we may also refer to them as New Appointees and Variations, or NAVs.

An SLP is not an appointee but an accredited, specialist provider of water pipes and associated infrastructure and services in accordance with agreements with water companies made under section 51A of the Water Industry Act 1991.

Frontier Economics concluded the economic rationale for having income offset is weak and could be removed.

- Water companies and one NAV (IWNL) largely agreed with the key principles and conclusions.
- Bristol Water disagreed with the conclusions on the income offset, saying that the income offset reflects the resilience and capacity benefits to existing customers and that its removal would cause a significant increase in developer charges which would not necessarily be compensated through greater environmental incentives.
- Three developers (Barratt Homes, Persimmon Homes, Vistry Group) and two consultants (WA Consultancy and TDS) mainly disagreed with the report:
    - They believed the report failed to recognise their view that developers provide an income-generating asset to water companies;
    - They said that the "user pays" principle does not reflect that the "users" are home buyers, not developers;
    - In their view, new assets will have lower maintenance costs than older assets, thereby saving water companies money, but the report does not consider this in detail, although it states new assets also incur maintenance costs;
    - They said house prices are determined by the market value regardless of the water and sewerage infrastructure requirements.

Frontier Economics concluded it would be more cost-reflective and in line with the principle of cost causation if developers did pay for all the off-site costs that they cause. The report also recommended exploring more cost-reflective charging for network reinforcement, such as having charges that reflect difference in costs in different locations.

On paying for all off-site costs that are incurred as a consequence of new developments:

- the "user pays" principle was largely accepted by most water companies and IWNL, while recognising the challenges to charge developers for strategic assets, stating that new developments are not likely to be the key driver for those costs.
- Wessex Water supported charging developers for strategic assets and agreed that requiring developer contributions to the cost of strategic assets is aligned with the "user pays" principle.
- Thames Water agreed it is appropriate for developers to contribute to the costs of property growth in full. It also said that the current rules may result in developers not paying the full costs of network reinforcement (particularly when the development spans more than five years).
- Barratt Homes, Persimmon Homes, Vistry Group, WA Consultancy and TDS thought that any change in the approach to payment for strategic assets would need a change to legislation.

On greater use of locational charging structures:

- Overall, the consultation responses did not support the conclusions and recommendations of the Frontier report.
- The key arguments against those proposals were that such charging structures
    - would add complexity (which respondents said is not supported by developer customers) and
    - would not be able to send effective price signals and influence locational decisions. This is because the water infrastructure costs are relatively low compared to overall house building costs and the planning process and housing market specifics are the key drivers for locational decisions.

Barratt Homes, Persimmon Homes, Vistry Group, WA Consultancy and TDS commented that in their view, the report does not recognise that houses are built based on planning decisions, which go through a consultation process, and are not determined by developers.

The Frontier report suggested the time horizon for recovering network reinforcement expenditure could be lengthened, as water companies make investment decisions for planned developments over a longer time period[2]. Several water companies agreed, suggesting a 10-year time horizon for setting infrastructure charges, years rather than the five-year rolling period set out in our charges scheme rules.

2.4 Responses to Question 2

2.4.1 Charging for strategic assets

What we said in our April consultation
The Frontier report concluded that there is no clear economic rationale for developers to pay less than full costs of developments, including the costs of strategic assets, but that they should only pay their share of costs where additional demand is also driven by existing customers. We agree with this in principle. Our view is that most costs of strategic assets are associated with population growth, and would still be incurred under a counterfactual of no new development but still with a growing population. In contrast, developments affect population distribution within a locality, and hence costs of network reinforcements are incurred as a result of developments. This provides a rationale for treating the recovery of network reinforcements differently from strategic assets. We therefore propose to retain the current framework that developers do not contribute to the costs for strategic assets, except in the form of environmental incentives.

[2] See p65 of the Frontier Report.

Respondents' views

The majority of respondents agreed that developers should not be charged for strategic assets, as there are other key drivers to costs of strategic assets rather than new developments, such as population growth and investments for environmental improvements. Some respondents also said that it would not be practical or reasonable to allocate those costs between developers and other customers.

- Yorkshire Water said that while it supported the user-pays principle in this area, it would be very challenging to allocate costs accurately.
- South East Water, Wessex Water and Portsmouth Water suggested that developers should be contributing to the costs of strategic assets. They agreed with the conclusions of the Frontier report and viewed new developments as the key driver for costs of strategic assets.

Our view

Respondents made a number of relevant points in this complex area that were not captured in our original consultation. Overall, there is strong support from stakeholders for keeping costs of strategic assets outside the scope of new connection charges. We acknowledge there is a minority view to the contrary.

We do not agree with the suggestion that changes to primary legislation would be needed to require developers to contribute to these costs.

We recognise that there might be instances where it would be in the commercial interest of developers to make contributions to strategic assets in order to address environmental requirements to support planning applications. We do not wish to rule out changing our charging rules at some point in the future to facilitate this.

Subject to the above, we confirm our proposal to retain the current arrangements that developers do not contribute to the costs of strategic assets, except in the form of environmental incentives.

2.4.2 Income offset and balance of charges rule

What we said in our April consultation
The Frontier report concluded, with detailed reasoning, that there did not appear to be a clear economic rationale for income offset. We agree with its finding. We therefore propose to remove the ability to offer income offset for English companies from April 2025 onwards, and remove the balance of charges rule at the same time. These changes are timed to coincide with our PR24 determinations. For the companies that currently apply income offset, this can be expected to increase developers' bills. However, there are offsetting factors; for example the increasing competition that we are seeing from SLPs reducing bills.

Respondents' views

Most water companies and CCW agreed there is little rationale for having income offset and supported the proposed reform to remove income offset and the balance of charges rule. Some respondents said that introducing the proposed reform needs a more detailed impact assessment, extensive stakeholder engagement and more detailed thinking on implementation.

- Severn Trent and United Utilities suggested that the reform could be phased over AMP 8 to minimise annual increases in charges. Both proposed a 10% limit to annual bill increases. Similarly, IWNL noted the importance of transitional arrangements for bill stability.
- Severn Trent said that we could consider Frontier's option of rebranding the "income offset" as a "company contribution" used to promote environmental incentives.
- United Utilities expressed serious concerns with the proposed reform. It said removal of the income offset could have a negative impact on Government's strategy to build more homes and significantly increase overall revenue being recovered from developer customers in the North West
- IWNL and Anglian Water also highlighted the Government's focus on increasing the housing supply and questioned if the proposed reforms, which would lead to greater contributions from developers, are fully aligned with government policy.
- Bristol Water disagreed with the removal of the balance of charges rule. It said the rule maintains stability in charges and its removal could result greater fluctuations in charges (and disproportionately affect smaller developments). It also said that the balance of charges rule was driven by Government policy. Defra would need to amend its charging guidance to Ofwat, because it contains guidance on the balance of charges.

- WA Consultancy, Barratt Developments, TDS and Vistry Group stated that the balance of charges remains ambiguous and monetary evidence will help define what it is. They also argued that removing the income offset runs contrary to Defra's charging guidance and that there is nothing in the Water Industry Act 2014 that repeals the provision of an income offset.
- Persimmon Homes stated that there cannot be removal of charging elements without being replaced by elements of equal value.

SLPs and IWNL commented that the proposed reform would not have an impact on their business. In addition:

- FWC suggested that infrastructure charges and income offsets should be set by Ofwat and fixed for 5 years. This would provide more price stability and certainty over the duration of a development. It also noted these types of charges cannot be effectively "policed" by SLPs or other market participants and customers. Similarly, LMAM said water companies should offer "scheme terms" that remain fixed for the duration of a scheme.
- FWC and LMAM also suggested that infrastructure charges and income offsets should be set in a way that passes them directly to developers rather than SLPs having to deal with them, as these are pass-through costs for SLPs.
- PN Daly and Persimmon Homes suggested removing infrastructure charges and income offsets and replacing them with a single charge per new connection.

Our view

In this section we first respond to points relating to rationale for income offset and its proposed removal. We then discuss the balance of charges rule, before responding to points made by SLPs regarding infrastructure charges. Finally we consider issues regarding implementation, impact and stability of bills.

Having reviewed responses made, we confirm our view that there is no convincing economic justification for having income offset. We consider that any discount or surcharge reflecting environmental or social issues should have a clear rationale.

We are not persuaded by the argument made by some stakeholders that developers are giving water companies an asset and therefore should be compensated by water companies. This point was discussed in detail in the Frontier report[3], which rejected its rationale and explained that the relevant infrastructure can be viewed as a liability as much as an asset for water companies.

[3] Frontier Report, page 39.

We do not accept the view that Ofwat cannot make this decision because the provision of an income offset has not been repealed in the Water Industry Act 2014. The Water Act 2014 gave Ofwat powers to issue charging rules, including charging rules for new connection services.

Levels of income offset vary substantially across water companies, and we have set out our assessment of these impacts in Appendix 1. For some water companies, removing income offset would have little or no impact. For others, its removal would represent a significant increase in developers' bills (of up to around 50%, or up to 0.3% of the price of a new house in that area) and corresponding reduction in water bills. These changes would be predictable because they are being planned some years in advance. We discuss implications for bill stability and implementation below.

We recognised in the past that companies did not interpret the balance of charges rule consistently. We consider that we addressed this in our 2019 consultation, subsequently brought into effect in April 2020, when we clarified the rule to ensure companies take into account all costs associated with developments and charges paid by developers. We also explained that the balance of charges is maintained by varying income offset. We note the balance of charges is set out in more detail in the Frontier report (page 54).

Our consultation explained how we have had regard to Defra's charging guidance in making our proposals.

Removing the balance of charges rule would make new connection charges more cost-reflective, as the current rules require companies to maintain relevant levels of contributions from developers and other customers as they were before 2018 (when we introduced the new connection charging rules).

We note the comments from SLPs about having infrastructure charges and offers from water companies that are fixed in duration. Such issues are out of scope for this consultation, but we addressed these points in our August consultation on updating our charging rules.

We agree with respondents who highlighted the importance of bill stability. Bill stability is a principle set out in our charging rules, with an increase above 10% for certain typical developments requiring companies to undertake impact assessment and additional engagement. As shown in Appendix 1 (table 3), for some companies, removing income offset could result in developer bills increasing by more than 10%. The overall impact on bills would need to be assessed within the wider context of other reforms and issues, such other changes to improve the cost-reflectivity of charges, wider use of environmental incentives, any changes associated with PR24 and lower charges levied by new appointees and SLPs.

We are therefore confirming our intention to remove income offset from April 2025, but will give further consideration to implementation on grounds of the principle of bill stability. While bill stability is an important charging principle, it needs to be balanced against other charging principles and the disbenefits of any increase in regulatory complexity.

We will also remove the balance of charges rule from April 2025 to support cost-reflectivity. We think this is in the best interest of customers and the removal of the income offset will deliver better value for money for customers overall. Removing income offset will make charges more cost-reflective to support the objective that end customers do not fund companies' costs that are a consequence of new developments or vice versa.

2.4.3 Network reinforcements

What we said in our April consultation
The Frontier report concluded that there was merit in replacing the existing average infrastructure charge with price signals, for example to reflect local capacity constraints more effectively. We do not propose to prevent companies setting simple infrastructure charges for most developments. This is because we consulted on this issue in 2019, and gathered additional evidence as part of our review of incumbent company support for effective markets (RISE), which we published in 2020. We accept that many developer customers prefer the benefits that these highly averaged charges bring. In the most remote locations, away from the existing sewerage network (and potentially even the water network), however, we think that the benefits of differential infrastructure charges may be stronger. For example the price signal of the incumbent may allow a NAV to offer a lower cost solution, such as a local treatment works. We are therefore considering whether for English companies to have a requirement of more bespoke infrastructure charges for some of the most remote developments. For such developments, we propose that the infrastructure charge would be published but it would be set according to cost drivers, for example the length of network reinforcements required.

Respondents' views

Respondents did not support greater variation in infrastructure charges to reflect geographical cost drivers, highlighting complexity in setting bespoke charges for remote locations and distributional issues from such differentiation (potentially higher charges in rural areas that might otherwise benefit more from new developments). One NAV supported allowing companies to do that and we note this is already allowed under the charging rules.

Several respondents suggested that more detailed definition of "remote locations" is needed with regards to our proposal to consider having a requirement of more bespoke infrastructure charges for some of the most remote developments. Only one company suggested such type of charging could be beneficial.

Our view

In the light of responses, we do not think the benefits we aimed at delivering with this proposal, including reducing barriers to competition for full-service NAVs, outweigh the issues highlighted by stakeholders. We do not intend to pursue this proposal further and will not introduce a new requirement in the charging rules. However, we will retain the current flexibility in charging rules that allows, but does not oblige, companies to vary infrastructure charges by location.

2.5 Responses to Question 3

What we said in our April consultation

We propose to have rules that define charges or discounts relating to environmental impacts, with the expectation that there are incentives for water efficiency and reductions in surface water drainage.

To better support third party providers, the environmental incentives should be applied at the point of new connection, and not earlier in the process.

We see environmental incentives as being largely separate from infrastructure charges: they would only be reflected in infrastructure charges directly to the extent that they reflect savings to costs of network reinforcements.

Prior to 2025, as we are proposing to retain the balance of charges rule, the size of bills overall will be broadly maintained. However, those with more sustainable development would benefit from discounts and those without sustainable development would pay relatively more.

Respondents' views

There was strong support across the sector for the need to do more to achieve better environmental outcomes, including further collaboration and research to design effective charging incentives. Several respondents commented that other measures can have a greater impact on developers' activities in this area, such as more ambitious building regulations and planning processes and government legislation related to water efficiency.

- CCW, Yorkshire Water and Wessex Water said some current incentives need to have verifiable benefits to ensure they are not simple funded by existing household customers.

- Thames Water, South West Water, Sutton and East Surrey Water and United Utilities said incentives should only be used for outperforming planning processes and building regulations or for exemplary practices.
- Severn Trent and TDS commented that the current water efficiency incentives across industry have an issue with longevity, as efficient fittings can easily be removed by homeowners.
- CCW, Anglian Water, Portsmouth Water, South West Water and Thames Water questioned the effectiveness of discounts offered by some companies for water efficient fittings and measures that reduce flows to the network, for example take-up may be low and compliance may be poor.
- TDS added that that SLPs are currently not being incentivised in any way. Similarly, Severn Trent and IWNL noted that any regulatory incentives need to recognise the role NAVs can play and consider a mechanism that works for NAVs as well.
- Anglian Water suggested that using incentives on a larger scale (e.g. across the entire site) would be more effective (e.g. including more multi-functional drainage features, reuse systems or offsetting demand through retrofit elsewhere).
- Skewb, Waterwise, Southern Water, South West Water, Sutton and East Surrey Water, Thames Water and South Staffs Water suggested discounts should be provided for Grey Water Recycling and Rain Water Harvesting.
- Affinity Water commented that larger incentives could create tension with charging principles, such as cost-reflectivity of charges.
- Southern Water and Severn Trent suggested that income offsets can be distributed in a way that incentivises environmental outcomes, rather than being offered to all new developments. Southern Water also suggested that incentives for water efficiency and SuDs can be made mandatory in the charging rules for new connection services.
- PN Daly, Skewb, Persimmon Homes and Portsmouth Water said there should be greater consistency in the discounts that are offered, through changes in the charging rules or companies' licences.
- Anglian Water and United Utilities suggested that reforms to deliver environmental objectives should also include removing/reviewing the automatic right of developers to connect surface water drains to combined sewers.
- Waterwise suggested the use of incentives to be used to encourage consideration and adoption of water neutrality in new developments, particularly for larger developments in areas of serious water stress. Thames Water and Skewb explained they are members of a Waterwise sub-group developing the definition and delivery opportunities for achieving water neutrality on new developments. This is being piloted with a leading housing developer for a large-scale development site in London – the project seeks to achieve a water neutral outcome by saving enough water in surrounding existing developments to offset the projected new water demand of the new housing. Thames Water has been considering the possibility of allocating the income offset that would have been paid to contribute to or completely fund the delivery of large-scale retrofitting and internal wastage fix activity within the same water resource zone as the development.

- Thames Water and South East Water suggested that now would be a good time to revisit rising block tariffs for household customers.

Our view

Consultation responses confirm the importance of having more water efficient new homes and having more scope for incentivising schemes such as greywater recycling and sustainable drainage.

There was a rich discussion across the responses with a number of thought-provoking suggestions, which we need to consider in greater detail.

We agree with the points made that incentives can only be a small part of overall work to improve the sustainability of new developments – with particular reference to their water efficiency and drainage. Engagement and communicating with developers in good time is as important as the incentive design, and the incentives will likely rely on technical information specified elsewhere, such as in building regulations, water efficiency labelling or asset adoption arrangements.

We will undertake and publish a review of water companies' approaches to setting, communicating and engaging on environmental incentives for 2022-23, highlighting good and poor practice, to strengthen their use and effectiveness.

We look to the sector to collaborate and innovate on developing more effective incentives, sharing good practice where possible. We expect water companies to step up and encourage more sustainable new developments through their new connection charges. For example, companies may consider offering larger income offsets for water and waste efficient development until 2025 (within the balance of charges).

We are not going to change our charging rules for 2022-23 to introduce new requirements on water companies regarding environmental incentives because companies are already permitted to do this (and some do). We will consider future changes alongside our broader work on environmental sustainability, developer services and PR24.

3. Wider work on developer services

We know the developer services market is evolving and the changes we have put in place are benefitting customers. But we believe the market has yet to reach its full potential. For example, in our review of incumbent company support for effective markets, we found there is room for companies to play a more active role in supporting developer services, notwithstanding the progress made by some and the examples of good practice we have seen. In addition, the work prepared by CEPA on the regulation of developer services at PR24 sets out options for how we can improve our regulatory approach.

Our April consultation is part of this wider programme of work on charges for and regulation of developer services. This chapter sets out our programme in more detail.

3.1 Improving cost-reflectivity

In the developer services market, like elsewhere, it is vital that customers and other stakeholders have confidence that charges for services reflect the reasonable costs of providing them. Such cost-reflectivity is at the heart of our regulatory approach. Our programme of work seeks to improve the cost-reflectivity of charges and encourages companies to play their part. For example:

- We have conducted further analysis of companies' costs and charges for new connections, including a report, prepared by Sia Partners, on companies' costs and charges for new connection services. We expect incumbents to review the findings of the Sia Partners' report to establish how they might improve the cost-reflectivity of their charges for 2022-23, consistent with the principles in our charging rules.
- CEPA found, in its assessment of possible options for the regulation of developer services at PR24 and beyond, found evidence that the level of competition in developer services is increasing and there may be ways in which competition could be enhanced further. It also found that some stakeholders were concerned about the way cost allowances were calculated in PR19 and that incremental improvements to our regulatory approach could be made.
- We implemented CEPA's suggestions on additional data collection to better inform the decision on which approach to take forward for PR24 in our August 2021 request for data. We are currently analysing companies' submissions.
- We have updated our charging rules, which will come into effect in April 2022. One of the changes we made, which was widely supported by consultees, was to emphasise more strongly the need for charges to be cost-reflective. We have done this by introducing a new principle of cost-reflectivity into the English New Connection Rules.

3.2 Supporting markets

Markets are important because they can deliver benefits for customers, society and the environment. They drive efficiency and innovation, encourage companies to improve their performance, as well as offer greater choice and quality of service and lower prices. Incumbent water companies need to actively support markets if they are to work well and help everyone in the water sector meet the strategic challenges we face.

We are committed to improving developer services and welcome the efforts by a number of companies to increase their support for an effective market. David Black, Interim Chief Executive of Ofwat, reaffirmed this commitment in his letter to companies on 16 September 2021. In his letter, he explained that some companies have substantially improved their support for developer services markets, but Ofwat expects all companies to reflect on the improvements they can still make.

It is important that, when implementing environmental incentives and other changes to their charging arrangements, water companies consider how they can do this in a way that supports markets.

Appendix 1 – assessing the scale of income offset

To facilitate understanding and discussion of our proposal, we summarise in this section some information about income offset provided by water companies. It is clear from this information that companies and their stakeholders will be affected to a different extent from any proposal to remove it. Table 2 shows the income offset and infrastructure charge for companies in 2021-22. Our proposal to remove income offset would not affect those companies that do not offer income offsets (two on water, four on waste).

Table 2 – Infrastructure charges and income offset (per connection) 2021-22[4]

	Infrastructure Charge – Water	Income Offset – Water	Infrastructure Charge – Wastewater	Income Offset – Wastewater
Anglian Water	£342	£402	£573	£0
Northumbrian Water	£65	£0	£235	£0
Severn Trent	£355	£527	£320	£81
Southern Water	£0	£574	£335	£128
South West Water	£88	£398	£649	£88
Thames Water	£400	£230	£365	£15
United Utilities	£302	£778	£279	£0
Wessex Water	£239	28% reduction in infra charge	£596	22% reduction in infra charge
Yorkshire Water	£75	£0	£205	£0
Affinity Water	£249	£387	n/a	n/a
Bristol Water	£273	£686	n/a	n/a
Portsmouth Water	£334	£485	n/a	n/a
South East Water	£570	£563	n/a	n/a
South Staffs Water	£305	£660	n/a	n/a
Sutton and East Surrey Water	£417	£415	n/a	n/a

Source: Ofwat analysis of water companies' charges.

[4] Amounts rounded to nearest £.

Table 3 summarises the impact offsets as a percentage of typical bills for developer services under three scenarios – single connection, a small development with 10 properties and a medium development with 50 properties. We have used the figures on new connection charges (connection and requisition charges) from the Sia report (analysing the root cause for variations in new connection charges) and included the relevant infrastructure charges and income offsets from companies' charging arrangements for 2021-22.[5] It is evident that developer customers in different areas will be affected to a different extent, and it is important to consider implementation of future reforms as a package. We see scope for reforms on environmental incentives to mitigate some of the effects on bills for developer customers.

Table 3 – Income offset – proportion of typical bills for developer services under three scenarios

	Income offset - % of typical bill scenario for a single connection	Income offset - % of typical bill scenario for a small development (10 properties)	Income offset - % of typical bill scenario for a medium development (50 properties)
Anglian Water	17%	18%	22%
Northumbrian Water	0%	0%	0%
Severn Trent	17%	23%	36%
Southern Water	56%	40%	45%
South West Water	17%	24%	32%
Thames Water	6%	7%	7%
United Utilities	30%	30%	31%
Wessex Water	5%	7%	7%
Yorkshire Water	0%	0%	0%
Affinity Water	11%	18%	21%
Bristol Water	28%	31%	34%
Portsmouth Water	20%	23%	27%
South East Water	25%	26%	33%
South Staffs Water	27%	35%	47%
Sutton and East Surrey Water	26%	20%	24%

Source: Ofwat analysis, Sia Partners' analysis of new connection and requisition charges.

The income offset represents a small proportion of the average new build house price in England. Data from the ONS for July 2021 shows the average new build house prices in

[5] For water and sewerage companies, we have taken into account the combined water and sewerage income offsets and infrastructure charges.

England vary between £213,065 in the North East to £522,846 in London. The income offsets (excluding Northumbrian Water and Yorkshire Water as they have discontinued offering income offsets) represent 0.05% – 0.3% of average new build prices.[6] We acknowledge the distinction between revenue derived from the sale price of a house and profitability, however we do not anticipate the home building agenda to be materially affected by removing the income offset. We also note stakeholders' responses to our proposal on zonal charges, discussed in the next section, that the costs of water and sewerage infrastructure are proportionately small compared with overall cost drivers of new developments and are not likely to affect decision making by developers.

Table 4 shows the average annual amount of income offset per household property and its value relative to average household bills. On average income offset is equivalent to £6 per household per year, which varies between £0 (for the two companies that do not offer an income offset) to £16 across English companies. In comparison, the average contribution from household customers to fund social tariffs in 2020-21 is £4 (the level of contributions varies between £1 and £11).[7]

Income offsets represent about 1.5% of the average combined water and wastewater bill in 2019-20.[8] While removing income offset would not be equivalent to this reduction in household bills (because the impact would be spread across non-households and retailers and across a number of years), removing this discount could help support affordability of household bills in the longer term.

Table 4 – Income offset – average amount per household (HH) property

	Income offset per HH property (£/year for 2020/21-2024/25)	Water only companies – Income offset – % of average HH water bill 2019-20	Income offset – % of average HH combined bill 2019-20
Anglian Water	£16	n/a	4%
Northumbrian Water	£0	n/a	0%
Severn Trent	£9	n/a	3%
Southern Water	£11	n/a	3%
South West Water	£4	n/a	1%
Thames Water	£3	n/a	1%

[6] Ofwat analysis, ONS House Price Index July 2021.
[7] Ofwat analysis of APR submissions, Table 2N.
[8] For water and sewerage companies we have taken into account the combined water and sewerage income offsets. We have used the number of household properties from companies' submissions on average bills as part of our charging information requirements.

United Utilities	£8	n/a	2%
Wessex Water	£2	n/a	0%
Yorkshire Water	£0	n/a	0%
Affinity Water	£3	2%	n/a
Bristol Water	£8	4%	n/a
Portsmouth Water	£2	2%	n/a
South East Water	£5	3%	n/a
South Staffs Water	£5	4%	n/a
Sutton and East Surrey Water	£1	1%	n/a
English water companies – total	£6	2.5%	1.5%

Source: Ofwat analysis, Frontier Economics analysis of annual reporting data.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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