A Consultation on the Scope and Balance of Developer Charges and Incentives

Consultation response from Yorkshire Water
8 June 2021

The responses from Yorkshire Water (YWS) to the questions below refer to the consultation launched by Ofwat on the 27 April 2021, on developer charges and incentives and considers the findings of a report commissioned by Ofwat from Frontier Economics.

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

The key conclusions from the Frontier Economics (Frontier) report are summarised below along with our commentary for each conclusion under a separate heading.

Frontier Key Conclusions

- **Conclusion 1.** It would be more cost-reflective and in line with the principle of 'cost causation' if developers pay for all off-site costs in consequence of new developments. Currently developers do not contribute to the costs associated with works on strategic assets, such as treatment works.
- **Conclusion 2.** The economic rationale for a key industry discount, the income offset, is weak. The Frontier report proposes options for reform, which include removing it completely, and using the value to strengthen environmental incentives or linking it better to company costs.
- **Conclusion 3.** Alternative approaches to charges and charging structures could do more in promoting social and environmental incentives.

Yorkshire Water commentary

- **Conclusion 1 - developers pay for all off-site costs**

We agree in principle with Frontier that developers should contribute to the cost of new or upgraded strategic assets where this can be explicitly linked to the concept of cost causation.

However, this approach could be difficult to apply particularly through infrastructure charges (IC’s) which recover expenditure on network reinforcement. The conclusion from Frontier assumes a clear delineation exists between investment driven by new developments and their future demands on water and wastewater services as quality or resilience driven investment schemes, for existing and future customers, which are difficult to separate in practice.

We also observe the Frontier proposal could drive material volatility in charges to developers due to the short cost recovery time period of the current charging method. The current methodology averages cost recovery through IC's over a five-year rolling period. Significant investments in strategic asset schemes typically follow a longer cost recovery profile (currently collected from the generality of customers) and directing such cost recovery to developers through IC's, might disadvantage developers where IC's would be significantly higher. Indeed in Frontier's own analysis of companies AMP7 investment plans, the inclusion of the recovery of investments in strategic assets into developer services charges would have driven an estimated uplift of between 38%-66% to developers gross bills (under Option 2 Low-High in the Frontier assessment), collecting between £1.4bn to £2.5bn more over the five years. When AMP7 income offsetting is considered the average estimated uplift experienced could be between 47% to 81% on net bills. If we assume investments on strategic assets for AMP8 would be of a similar order across England, we could see some significant movements in developers bill levels for each year of the period and beyond.

We note the counterfactual case Ofwat puts forward that population growth is the general driver for upsizing or building new resource and treatment capacities (i.e. investment in strategic assets), rather than the building and serving of new houses directly. We see some merit in this position but also acknowledge that new houses built in unserved locations may need new treatment capacity. On this basis, material population growth occurring in new locations may create a differential level of investment in capacity that could justify a unique charge.

Overall, we remain open to a review of the boundary where investments are designated for recovery from developers or from the generality of customers (as expressed in the well-used diagram presented on page 12 of Frontier's report). However, it will be essential to have a detailed understanding of which customer groups (revenue streams) are associated with the drivers for new or enlarged strategic assets and how to evaluate or isolate the specific costs for recovery. Where new assets replace previous capacity due to transition to new technologies, for example to address net zero challenges, cost recovery will most likely remain with the generality of customers. This will ensure current and future customers can be satisfied that the spread of cost recovery is fair and that incumbents can maintain cost reflective developer charges aligned to charging rules as they are conveyed in future.

- **Conclusion 2 – removal of income offsets**

YWS has not operated any income offsetting for developer services charges since 2018.We removed income offsets from our charges following a detailed study that established we were 'in-balance' in respect of our expenditures and revenues attributed to developers. There was no long-term cross subsidy position in place that subsequently needed to be maintained between developers and our other customers. We periodically check that this expenditure to revenue balance position is maintained.

A summary of our study is published in the following paper: https://www.yorkshirewater.com/media7/1517/assessing-the-balance-of-developer-charges-and-setting-infrastructure-charges.pdf

We agree with Frontier that the income offset should be removed from the charging approach by 2025. We observed that the legacy income offset arrangements alongside the standard infrastructure charge applied nationally were having the effect of moving some funds between one group of developers and another group of developers. We acknowledge that for some incumbents, the removal of the income offset altogether could result in them not being able to broadly maintain their historical distribution of costs between developers and other customers. This may require the endorsement of Defra, who would in effect need to remove that obligation.

We note Frontier's proposal to direct the value of income offset discounts to developers via other means, for example through new or enhanced environmental incentives for sustainable low water use homes, but we are concerned this presents its own challenges. Companies with no or very low value income offsets would not be able to redirect such funds without altering their respective balance of revenues to expenditures thus creating further differential approaches between regions. There could be very different 'environmental incentives' across the companies which may not be taken up in great numbers or not be reflective of the benefits achieved in terms of valuation of efficiency gained or natural capital improved.

Therefore, we are less aligned with the proposal that the current income offset value could be redistributed as an environmental incentive. Our decision to remove the income offset in 2018, was based on being in balance between charges and expenditures for developer customers so we would not realise any surplus to redistribute from the proposals on income offsets became policy from 2025. The incentive would be difficult for us to apply and would need to be funded by the generality of customers, creating a cross-subsidy where there hasn't been one.

- **<u>Conclusion 3 – social and environmental incentives</u>**

We agree that it would be beneficial to explore alternative approaches to charges to promote social and environmental incentives. Our current charges offer developers some financial reward for delivering environmental improvements against a no action baseline, particularly around the IC for surface water drainage (SWD) which is not charged where drainage of the properties and footprint is not directed to our sewer network. Currently developers can take advantage of a £150 per property avoided charge.

We do offer other incentives based on expected per capita consumption based on fixtures and fittings within the properties to be built, but they are of lower value and taken up less often in practice, even if they are relatively easy to achieve. We agree that more could be done to promote and design incentives that can be better targeted to developers or indeed to end customers to deliver improved and more sustained beneficial outcomes for YWS, our customers and our environment.

A more radical approach to water conservation may benefit from incentivisation, such as rainwater harvesting solutions at the initial build stage (potentially a cost advantage over retrofit solutions), and more localised focus in areas of known environmental stress. In our technical opinion this can only be achieved alongside strengthening of planning laws and better and consistent practices by planning authorities.

The benefits from incentive schemes should also be sustainable and auditable to ensure the incentives are self-financing rather than to the detriment of other customers through a continuous cross subsidy.

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

We are broadly in agreement with the proposals presented and we support the cost causation principle that developers should contribute appropriately towards the costs of **new or expanded strategic assets**. The counterfactual point put forward that population growth occurs regardless of new development highlights the difficulty is separating causation factors and who should pay for new investments between developers and existing or future customers which may be challenging to apply in practice. Should the policy direction lead towards a redefining of the current expenditure rechargeable boundary, we would welcome the formation of an industry working group to evaluate approaches and produce best practice guidance. In this way developers could share their views and have confidence in a consistent and fair approach is being applied by all companies with developers only being asked to fund growth investments they drive. Developers may also want assurances that lowest cost options have been delivered by companies, which may conflict with investment decision making based on appropriate valuations of wider benefits, such as the six capitals methodology.

We also understand the intent behind the creation of zonal IC's (charges that vary by geography based on the level of network reinforcement of a 'zone' within an incumbents region). However, we are concerned this could lead to frustrations from developers who are trying to build in support of latest house-building strategies from national and local governments. The sector may risk the perception it is exploiting house builders (both large and especially small) who are directly helping government meet their respective growth and levelling-up strategies. The sector needs be supportive of house-building needs and not be seen to be frustrating the delivery of wider policy.

Instead we believe we should be targeting 'better' house-building where it is needed. and that may mean we need to develop water or wastewater capacity in new places in the most environmentally sustainable way we can working collaboratively with developers and local planning bodies.

We also have concerns that zonal charges would bring more complexity to developer customers, including disproportionate impacts on smaller locally tied developers. From our latest consultations on our new connection charging arrangements we haven't seen any appetite from customers in general for zonal charges.

Our position on the **income offsets** has already been expressed in our response to Q2. and we are comfortable with the proposal to remove income offsets from 2025 along with the current **balance of charges rule** for English companies. This approach is more aligned to cost causation and could help simplify new connection charges across England, subject to any mandated introduction of environmental incentive schemes by companies.

We remain focussed on ensuring our new connection charges remain simple, cost reflective and enable other participants to continue to compete with us in the market.

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?

We currently operate incentives against our standard infrastructure charges to encourage developers to build low water demand housing (assessment based on planned fixtures and fittings) and do not connect their properties to our sewers for surface water. These incentives are offered equally to NAVs who can evidence their developer customer has met the same criteria.

There are challenges to setting attractive and proportionate environmental incentives within new connection charges for developers and NAVs (or indeed through bulk supply charges for NAVs exclusively). New environmental incentives should deliver verifiable and sustained benefits to water resource and/or wastewater management and ultimately to the environment and end customers. In designing incentives potentially with more financial reward to developers, we must ensure benefits are delivered and we are not simply remunerating theoretical benefits by moving monies from one group of developers who do not access the incentives to another group of developer customers who do.

At the short briefing session held on 19 May 2021, Emily Bulman from Ofwat expressed this challenge to those attending. We intend to take this forward by reaching out to other water companies, local authorities, and using our own expertise.