

# Approach to the regulation of developer services at PR24

Ofwat

24 May 2021



**FINAL REPORT**

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# EXECUTIVE SUMMARY

In the water sector, 'developer services' describes the activities delivered to connect new developments to the water and/or wastewater network. They can be broken down into site-specific work and network reinforcement.

Network reinforcement work is delivered by the incumbent water company in the area. In contrast, site-specific developer services activities are mostly contestable and can be provided by the incumbent water company, a new appointee (commonly referred to as a NAV<sup>1</sup>), or a self-lay provider (SLP<sup>2</sup>).

Ofwat regulates developer services via a number of processes, rules, and obligations. At PR19, Ofwat continued with its policy at PR14 of including incumbents' developer services income within the scope of the wholesale 'network plus' price controls. This meant that developer services revenue contributed to the overall revenue caps on wholesale network plus activities, with developer services income forecasted to comprise 2-10% of incumbents' requested wholesale network plus capital and operating expenditure requirements.<sup>3</sup>

Ofwat also introduced a series of incremental reforms to the price control regime it applied at PR14, including a new financial incentive for customer service in developer services ('D-MeX') and a revenue correction mechanism (the 'DSRA') to manage the uncertainty of new connection volumes during the price control. Ofwat is also active in regulating developer services outside of the price control through its charging rules, codes for asset adoption following the completion of a new development, and enforcement powers.

Ofwat is now at the start of the price review process, PR24, to design and implement the next set of price controls for the sector. In this context, Ofwat commissioned CEPA to develop and assess possible options for the regulation of developer services at PR24 and beyond. Ofwat's overarching aim for this study was to assess whether customers could be better served by developer services remaining in the wholesale price controls at PR24, or by reducing the regulation of contestable developer services and relying more on market outcomes.

## Competition in contestable developer services

Where they are carried out by an incumbent, contestable developer services activities are currently subject to price control regulation. The purpose of this study is to assess whether Ofwat's approach might be adapted over time depending on observed evidence of competition across the range of contestable developer services. Given that regulation is the status quo, we have not carried out a market definition or market study of developer services in England and Wales; e.g., to define the relevant product and geographic market(s) in developer services, or to identify specific market failures in supply and demand that could provide the economic justification for Ofwat taking a particular approach to regulating developer services within an agreed definition of the relevant market(s).

The absence of good quality information on competition in developer services presents a barrier to carrying out such a study on the basis of data currently available. For example, it is currently challenging to assess the degree of contestability across different types of new development (e.g., large and small) and different regions of England and Wales. One of the recommendations (see below) of this study is that better and more granular data is needed to assess competition and define relevant developer services markets, in order for Ofwat to reach decisions on whether and how to adopt alternative forms of regulation to the status quo.

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<sup>1</sup> New appointments and variations (NAVs) are limited companies which provide a water and/or sewerage service to customers in an area which was previously provided by the incumbent monopoly provider. A new appointment is made when a limited company is appointed by Ofwat to provide water and/or sewerage services for a specific geographic area. A new appointee has the same duties and responsibilities as the previous statutory water company.

<sup>2</sup> A self-lay provider is a contractor appointed by the developer instead of the incumbent water and sewerage company to undertake contestable new development work. This involves a process where the self-lay contractor undertakes the contestable work, with the incumbent water company then responsible for taking over responsibility for (adopting) self-laid pipes and any associated infrastructure once the work has been completed.

<sup>3</sup> Based on company requested costs at PR19. Source: Published PR19 final determination models (<https://www.ofwat.gov.uk/final-determinations-models/>).

As a result, within this study we refer to the ‘market’ or ‘markets’ in developer services in broad terms to guide and inform high-level options for regulatory policy at PR24 and beyond. This should not be interpreted to mean a formal view on the definition of relevant product and geographic market(s) in developer services is being provided.

We have, however used informal evidence of the current status of competition in developer services generated through the course of this work to guide and inform our development of regulatory policy options. For example, through informal stakeholder engagement and a project workshop undertaken during the study, stakeholders within the industry have informed us of the significant variation in competition for developer services across England and Wales. Stakeholders have told us how the degree of competition in contestable developer services can vary significantly between different types and size of connections, e.g., to the existing network (referred to as ‘infill development’) and larger developments that will typically involve greater infrastructure investment.

The market data that is available to us shows considerable regional variation in SLP/NAV market penetration across different regions of the country and suggests that the supply and demand for developer services tend to be local rather than national in scope. The anecdotal evidence is that competition in larger developments that involve new infrastructure is typically much greater than smaller developments.

## **Options for regulation of developer services**

Given the available, albeit limited, information on the current status of competition in markets for contestable developer services in England and Wales, we consider that price controls or other forms of binding restrictions on incumbents’ charges are likely to be needed in some form for all, or parts, of incumbents’ contestable developer services during PR24, to achieve effective outcomes for all consumers within the sector.

The existing approach to regulation seeks to strike a balance between the use of markets and price control regulation, but we do not consider a simple ‘do-nothing’ option – i.e., a decision to apply the same regulatory approach and methodology to developer services as applied at PR19 – should be Ofwat’s starting point for PR24:

- Recent trends suggest that competition in contestable developer services is increasing. This might suggest that, even if not achievable in PR24, there is the prospect that Ofwat might over time rely more on the outcomes of markets than a more proactive regulatory approach via price control regulation.
- There may be ways in which Ofwat can improve outcomes for consumers via changes to the approach to regulation that might improve incentives for competition from incumbents as well as NAV and SLP providers of contestable developer services.
- The CMA was generally supportive of Ofwat’s approach to assessing incumbents’ costs associated with new developments at PR19. But this was a contentious area of the price review with concerns raised by some stakeholders, in particular incumbents, that the existing treatment of developer services may not always adequately permit incumbents to recover their efficient costs.

With improved data and time, there may be at least incremental improvements that can be made to the cost assessment at PR24 to address some or all of these concerns, particularly if there is increasingly evidence that the cost drivers for developer services vary considerably between companies. That is to say, even if the form of price control regulation of developer services was largely kept the same as for PR19, there may be ways that Ofwat can improve the implementation of its current policy.

As we discuss in this report, there are a range of regulatory approaches and options that Ofwat might consider going forward that could help it to:

- set a more effective set of price controls at PR24; and/or
- potentially set a direction towards greater reliance on competition in developer services either at PR24 or looking beyond the current price review.

Our work suggests that Ofwat should focus on two high-level strategic options in formulating its strategy for PR24, each of which reflect different points on a spectrum of relying more or less on ‘ex-ante’ (i.e., price controls) versus ‘ex-post’ (i.e., monitoring and enforcement) regulation of developer services:

1. An evolution of the current regulatory approach, where all developer services continue to be price control regulated within the scope of the network plus price control, potentially with a view to a further transition towards more separate regulation or deregulation of developer services at future price controls.<sup>4</sup>

Under this option, the focus for PR24 would be on:

- cost assessment improvements, which could be enabled through enhanced data collection; and/or
  - improvements to the design of the existing price control regulatory framework, e.g., targeted changes to the existing volume driver for new connections (the DSRA) tailored to evidence of variation in the unit costs of different types of new development.
2. A more fundamental change in the approach to regulating developer services at PR24 that would be more reliant on ‘backstop’ regulation of contestable developer services, akin to Ofgem’s approach to regulating electricity new connections.<sup>5</sup> Under this option:
    - Contestable developer services would be excluded from the network plus price controls but would initially be subject to a capped profit margin (either zero or positive).
    - Non-contestable work would be expected to remain within the scope of the wholesale network plus price control.<sup>6</sup>

The focus for PR24 would initially need to be on collecting appropriate market data and information to undertake a more definitive definition of developer services product and geographic markets to allow Ofwat to reach decisions on whether there is adequate evidence of competition for contestable developer services to be excluded from the wholesale network plus price controls.

Should Ofwat conclude that within contestable developer services the market data indicates that existing constraints can be removed, there may still be the case for a transitional period with alternative protections. Were there to be evidence of limited competition it still may be desirable to exclude developer services from the wholesale network plus price controls, either at PR24 or in future. In either event, Ofwat will then need to be mindful of how to mitigate the risk that incumbent companies use the change in regulatory treatment to seek to exploit any market power they may have in contested or less contested segments of developer services. There is a risk that this may arise via the profit margins incumbents seek to earn from contestable developer services and/or via the approach they take to cost allocation following a change in regulatory approach:

- The profit margin that can be earned by incumbents for activities excluded from the wholesale price control would need to be constrained by:
  - Ofwat’s regulated cap on the allowed margin (zero or positive), where it would be assumed that competition in the relevant developer services market segment is not sufficient to constrain incumbents’ charges; or

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<sup>4</sup> Referred to as Option 1a in this report.

<sup>5</sup> Referred to as Option 2 in this report.

<sup>6</sup> A decision would be needed as to which elements of developer services work were initially treated as ‘contestable’ from the perspective of its price control treatment. A natural option would be to treat site-specific work as contestable and network reinforcement as non-contestable for this purpose. Anecdotal evidence from stakeholder engagement has indicated that close to 100 percent of site-specific developer services work is in principle contestable.

But Ofwat may judge it appropriate to treat certain activities that are contestable in principle as being non-contestable for the purpose of implementing Option 2. In order to simplify the drafting and narrative we have simply used the labels ‘contestable’ and ‘non-contestable’ without seeking to resolve, at this stage, the precise activities that fall into each category.

Option 2 is flexible and there is scope for the activities treated as ‘contestable’ to change over time. However, given that we assume the ‘non-contestable’ activities would be subject to benchmarking and cost assessment within the price control, it is likely to add significantly to the complexity of the regime if there is variation in the definition of ‘non-contestable’ activities *during* a price control or *between companies*.

- The pressures of competition for developer services that are not subject to an Ofwat regulated margin, where it would be assumed that a higher margin could only be sustained if the incumbent is offering better service/lower cost.<sup>7</sup>
- Excluding certain activities from the network plus price controls may incentivise incumbents to allocate developer service-related costs to activities that remain within the scope of the price control or to market segments where they face less competition, if this makes them more competitive in segments where there is greatest scope to earn additional profit margins.

As a result, Ofwat will need to ensure that there are clear cost allocation rules or principles in place that incumbents are bound to and which Ofwat could monitor and enforce over time.

We also considered the option of Ofwat implementing a separate price control, e.g., a separate revenue cap or price cap(s) for PR24.<sup>8</sup> This could be for all developer services, or just for contestable services with non-contestable services remaining within the network plus control. There would be a range of advantages of a separate control, but on balance we consider those benefits can largely be reflected in alternative approaches and the costs and negative consequences outweigh the benefits. The benefits of a separate price control are largely that it would:

- focus management attention on the particular activity thereby bringing efficiencies and quality improvements;
- allow Ofwat to focus on potential sources of cross subsidisation between different activities, which in turn would benefit competition through greater confidence that alternative providers are competing on equal terms, and on any volatility changing developer services revenues induce in end-customer bills.

Greater management focus is not necessary if competition is effective or is expected to be so. While greater transparency of a level playing field is important, we consider this can be achieved though requiring cost reflective charging combined with appropriate regulatory reporting. And, overall, the end-customer bill volatility caused by changing developer services revenues is small given the relative importance of developer service costs as a proportion of totex.

However, there would be a number of difficulties in developing a separate control including:

- Ofwat would need to develop a whole new set of price control arrangements for developer services, e.g., a new revenue cap or price cap(s) that introduce an appropriate balance of risk and reward for the activities undertaken under the scope of the price control.
- Undertaking a fully independent developer services cost assessment outside of the network plus price control may be challenging given that developer services are a reasonably small component of incumbent companies' cost base with a range of cost drivers.

We also consider that:

- Many of the key issues identified with the current approach to regulating developer services, can be resolved under a more evolutionary approach that would retain developer services within the scope of the wholesale network plus price control.
- The alternative backstop form of price regulation that we have set out above, could provide a more flexible approach for Ofwat to regulate developer services and place greater reliance on market outcomes rather than price regulation over time.
- Even once the separate developer services price control is created, Ofwat may still face similar challenges as with Option 2 should it wish to remove certain market segments from the scope of the separate

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<sup>7</sup> As an unregulated margin would only be permitted by Ofwat under this regulatory system in segments where SLPs or NAVs can compete against an excessive margin.

<sup>8</sup> Referred to as Option 1b in this report.

developer services price control where it observes evidence of strong competition and increasing the deregulation of developer services charges remains an objective.<sup>9</sup>

For these reasons, we conclude that Ofwat should focus on other options than a separate developer services price control for PR24. However, Ofwat may wish to consult with stakeholders on this conclusion before reaching a definitive position. In particular, whether stakeholders consider a separate developer services price control would be an effective steppingstone to a more fundamental change in regulatory approach at PR29 given the transparency of cost allocation that the separate price control would bring.

## Identifying a way forward for PR24 and beyond

The choice around what path to go down depends on the issues that Ofwat then wants to prioritise in PR24 (and beyond) with regards to developer services regulation and which approach, on the balance of probabilities, is most likely to meet the long-term needs and interests of new and existing customers. We have set out within this report the key factors that might help Ofwat reach an informed decision on this choice.

In isolation, and based on currently available information, Option 2 appears to be the more suitable ambition. Though it would require significant preparatory work ahead of PR24, in the long-term it offers the potential of a simpler approach to promoting customers' interests in contestable developer services.

However, this view is based on an uncertain assessment of the current state of the market. Ofwat is in the process of gathering richer data upon which to base this assessment, and some of its more recently introduced initiatives may have a further effect over time. Ofwat's final decision on which option to proceed with should take into account the opportunity cost of the preparatory work required, bearing in mind its other regulatory objectives. Given that we find the merits of options 1a and 2 to be finely balanced, it may be that even if in isolation Option 2 is preferable, Option 1a is a proportionate approach.

In the immediate term, there are a number of practical steps that Ofwat can take to help reach a future decision and which we recommend that Ofwat seeks to take forward during the next phase of the PR24 review:

1. **Develop enhanced developer services cost allocation guidance.** Ofwat should consider developing and introducing more prescriptive developer services guidance for PR24 to ensure that incumbents are allocating costs to developer services both consistently and accurately.

This may inform the practicality of excluding certain contestable developer services from the wholesale network price controls (i.e., Option 2) where cost allocation rules are a necessity and/or help to support the evolution of the treatment of developer services within the cost assessment at PR24 (i.e., Option 1a).

2. **Enhanced collection and use of developer services data.** This could enable Ofwat to conduct a more comprehensive 'state of the market' review. This may provide more confidence that an option that relies more on competition can be justified (i.e., Option 2) and enable implementation of such an approach.

Improvements in data (revenues, costs and mix of work/developments undertaken) may also be used to consider refinements to existing uncertainty mechanisms within the price control, e.g., the DSRA, and/or again to support the evolution of the cost assessment at PR24.<sup>10</sup>

Finally, Ofwat should consider how the depth of the charging boundary and the sharing of costs between developers and existing customers interacts with each option. Ofwat is currently consulting<sup>11</sup> on arrangements that would retain the existing 'semi-shallow' charging boundary (i.e., developers pay site specific plus local network reinforcement costs) but removes the income offset<sup>12</sup> from PR24.

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<sup>9</sup> Albeit that the process may be made easier as a result of the cost allocation processes put in place to implement the separate developer services price control.

<sup>10</sup> For example, the treatment of expected different programmes of growth activity between incumbent areas during PR24.

<sup>11</sup> See "[A consultation on the scope and balance of developer charges and incentives - Ofwat](#)", April 2021.

<sup>12</sup> A number of incumbent companies currently levy discounts to their developer services charges, known as income offset. Income offset is described in Ofwat's current English charging rules as being in recognition of revenue likely to be received by the relevant undertaker in future years for the provision of water and wastewater services.

Assuming that these are the charging policies for the sector in PR24, Ofwat would need to consider:

- What the implications and issues would be, if any, of developer services charges contributing to both wholesale network plus allowed revenue and excluded services from the price control (if it chooses to adopt Option 2 at PR24)?
- For Option 2, what risks and unintended incentives could exist around the cost allocation and charge setting processes for incumbents if certain activities are excluded from the price control, while others continue to be included in the wholesale network plus price control?<sup>13</sup>

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<sup>13</sup> For example, if certain strategic reinforcement works are included in the network plus price control but are recovered directly from developers via infrastructure charges, would the treatment of the investment within the price control totex allowances create new incentives around cost allocation between price-controlled works and works excluded from the price control.

# 1. INTRODUCTION

Developer services is one of the areas in the water sector that is open for competition. When a developer requires a new water and/or wastewater connection for a site, a request can be made to the incumbent water company or a new appointee (NAV<sup>14</sup>) to provide the necessary infrastructure and service the site. Alternatively, developers may choose a contractor to install the necessary pipework, which is known as self-lay, and may be able to do some of the work themselves. In this case, the water company will then take over responsibility of that infrastructure from the self-lay provider (SLP) or the developer through an adoption agreement.

Not all developer services activities in the water sector are contestable, however, and so some elements of the work are provided only by the local incumbent wholesale company.<sup>15</sup> In addition, while Ofwat has for a number of years supported competition in developer services, with significant SLP and NAV market penetration in some incumbent company areas, many developers still continue to rely on, or choose, their local incumbent company for the provision of contestable as well as non-contestable developer services.<sup>16</sup>

For these reasons, Ofwat has regulated incumbent water companies' developer services as part of their wholesale price controls in PR14 and PR19.<sup>17</sup> Price control regulation is supported by regulatory rules for developer services charging and other interventions to help support effective market outcomes.<sup>18</sup>

Ofwat's approach in PR19 reflected learnings from the treatment of developer services in the PR14 price controls and a set of stated aims to strengthen customer protections, improve customer service, ensure risk was allocated appropriately and to create an appropriate efficiency challenge for incumbents. In implementing its approach to developer services in PR19, Ofwat also sought to be internally consistent, considering its approach to cost assessment, expected end-of-period reconciliation process and new connection charging rules.<sup>19</sup>

While the first year of the PR19 price control period has only just been completed, Ofwat is now working towards publishing its first consultation document on the design of the next set of price controls, PR24, in May 2021. The initial PR24 design consultation document will be a key step towards producing draft and final methodology documents for PR24, setting the direction of travel for the price review.

In this context, Ofwat commissioned CEPA to develop and assess possible options for the approach to regulation of developer services in PR24 and beyond. In particular, Ofwat wants to understand whether customers would be served better by developer services remaining in the wholesale price control, forming part of a separate price control for developer services, or by reducing the scope of price control regulation for contestable developer services. The latter may include removing contestable developer services from revenue controls and allowing competition in the market to protect the interests of customers.

Ofwat's terms of reference require us to:

- Identify potential options for maintaining or reducing the regulation of contestable elements of developer services in PR24.

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<sup>14</sup> New appointments and variations (NAVs). NAVs are limited companies, appointed by Ofwat, which provide a water and/or sewerage service to customers in a specific geographic area which was previously served by the incumbent monopoly provider. A new appointee has the same duties and responsibilities as the previous incumbent.

<sup>15</sup> There can be exceptional cases, where it is efficient for a large development site to have its own discrete network (i.e., not connected to the incumbent's network), particularly for wastewater. In that case, the entire network is contestable in principle.

<sup>16</sup> This is particularly the case for wholesale water developer services. Contestable wastewater developer services are almost completely conducted by the developer themselves (i.e., self-lay), which maybe because accreditation is not required.

<sup>17</sup> For PR19, this means developer services income is retained inside the wholesale 'network plus' price control.

<sup>18</sup> At PR19, Ofwat also introduced a new customer service incentive – D-MeX – to encourage incumbents to provide developers and alternative developer services providers (i.e., SLPs and NAVs) with a good level of customer service. New mechanisms were also put in place to incentivise accurate developer services income forecasts from incumbent companies and the delivery of new connections via a revenue correction mechanism linked to the volume of connections termed the 'DSRA'. A more detailed description of the treatment of developer services in PR19 is provided later in this report.

<sup>19</sup> Ofwat (2019): 'PR19 FD: Our approach to regulating developer services', p. 3-4.

- Highlight how these regulatory changes could be achieved over time to maximise the potential benefits from facilitating effective competition.
- Consider what accompanying changes within the broader regulatory system in PR24 could be needed to implement a particular approach to regulation, e.g., to developer services charging rules.
- Prepare an assessment framework under which options can be considered and to assess options against relevant criteria to highlight potential costs and benefits of different approaches.

In developing options and recommendations Ofwat asked us to consider:

- regulatory frameworks for developer services in other sectors where contestability has been introduced (e.g., electricity and gas); and
- lessons that might be learnt from the experiences in these other sectors, to help Ofwat to formulate its own approach in PR24.

This study will help inform Ofwat’s thinking on the price control framework for PR24 and beyond.

## **1.1. OUR APPROACH**

We have approached our assignment in three stages.

First, we have undertaken a review of the existing regulatory treatment of developer services put in place at the PR19 review and the key issues and challenges that developer services create for the approach to regulation in PR24 and beyond. This “key issues” review has been used to inform the option development process.

As part of this step, we have completed a high-level review of competition in contestable developer services in England and Wales based on stakeholder feedback during the study. This has been informed by high-level published information on SLP and NAV penetration and informal stakeholder feedback provided during the study.

We have not carried out a formal market definition or competition study of developer services in England and Wales, e.g., to define the relevant product and geographic market(s) in developer services, or to identify specific market failures in supply and demand that could provide the economic justification for Ofwat taking a particular approach to regulating developer services within an agreed definition of the relevant market(s):

- As price control regulation of developer services is the status quo, we have focused our work on how Ofwat’s approach might be adapted over time depending on observed evidence of competition across the range of contestable developer services, consistent with the terms of reference for this study.
- Another reason for this has been the absence of good quality information on competition in developer services, e.g., the degree of contestability across different types of new development (e.g., large and small) and different regions of England and Wales.<sup>20</sup>

As a result, within this study we refer to the ‘market’ or ‘markets’ in developer services in reasonably general terms to guide and inform high-level options for regulatory policy at PR24 and beyond. But this should not be interpreted as a formal definition of the relevant product and geographic market(s) in developer services being provided.

Second, we have developed a set of broad regulatory approaches that Ofwat could in principle consider for PR24 and beyond, informed by the learnings from the PR19 and PR14 price review processes and experience/approach to new connections regulation in other sectors, in particular gas and electricity. For each option, we have defined a series of practical steps that might be needed or considered by Ofwat under each option: the “building block” options that make up possible strategic “pathways” for the treatment of developer services in PR24.

Third, we have undertaken an assessment of each of the strategic options we have developed and set out possible ways forward for developer services regulation at PR24 and beyond. Our assessment and recommendations have

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<sup>20</sup> As discussed in later sections of the report, one of the recommendations of this study is that better and more granular data is needed to assess competition and define relevant developer services markets, in order for Ofwat to reach decisions on whether and how to adopt alternative forms of regulation to the status quo.

been informed by better regulation principles, the specific context and objectives for developer services regulation in PR24 (e.g., supporting effective markets) and feedback from stakeholders.

We have engaged with water companies, SLPs and NAVs to produce this report, and the feedback we have received is reflected throughout the report to ensure that the options we propose are representative of the views of developer services market participants. This includes feedback from a workshop on the 9<sup>th</sup> March where our early stage thinking on key issues and options was presented to a range of stakeholders.

## **1.2. REPORT STRUCTURE**

The remainder of the report is structured as follows:

- Section 2 provides further background on developer services within the water sector and the current approach to regulation;
- Section 3 explores key issues in the regulation of developer services, drawing on stakeholder feedback and learnings from the PR14 and PR19 processes;
- Section 4 sets out the assessment framework we have used to analyse the possible trade-offs with different regulatory approaches;
- Section 5 sets out options for consideration;
- Section 6 sets out our assessment of the options; and
- Section 7 sets out overall conclusions from the study.

We also include two appendices that support the main report:

- Appendix A provides insights from how other sectors have approached the economic regulation of new connections/developer services activities.
- Appendix B presents the annual contestability summary, which sets out the minimum level of contestable works each water company must offer.

## 2. RELEVANT BACKGROUND

In this section we provide a more detailed description of developer services within the water sector and the current approach to their regulation.

### 2.1. DEVELOPER SERVICES WITHIN THE WATER SECTOR

The majority of water and wastewater services in England and Wales are provided by incumbent water companies, which are monopoly providers of some services in their areas of appointment.

However, some services in the sector are open for competition, developer services being one such area.<sup>21</sup> We use the term ‘developer services’ to describe the activities that are delivered as a result of new developments and can be broken down into site-specific work (new connections, water mains and sewer requisition, and diversions) and network reinforcement (local and strategic). Textbox 2.1 provides an overview of these services.

#### Textbox 2.1: Developer services activities overview

##### Site-specific work

- **New connections** relate to connecting new properties to a water main. This involves laying a communication pipe in the street from the boundary of a property to the closest water main. It also includes the installation of water meters and stop taps. Wastewater connections involve laying private and lateral drains, and related ancillaries such as maintenance holes, and are typically built by developers.
- **Water mains and sewer requisitions** relate to the design and construction of a new water main / sewer or extension of an existing water main / sewer. This is required if there is no water main / sewer near the connecting property, or the development includes the construction of a new street.
- **Diversions** are required if existing assets need to be diverted to allow new developments to be built.

##### Network reinforcement

Consists of incremental work needed to improve the incumbent water company’s existing network and can be broken down into ‘local’ and ‘strategic’ reinforcement:

- **Local reinforcement** relates to investment in existing water and trunk mains, break pressure tanks, water towers, booster pumping stations and service reservoirs, that are required as a result the additional demand placed upon it by newly connected properties.
- **Strategic reinforcement** relates to investments in strategic assets, such as water resources, water treatment works, and wastewater treatment works.

Source: CEPA

Network reinforcement (local and strategic) currently is only delivered by the local incumbent water company in the area. However, site-specific developer services activities are mostly contestable, meaning developers can procure these services from the incumbent water company, a SLP or a NAV.

As noted in the introduction, SLPs are organisations who can design and lay the pipework for a new water main or sewer instead of the incumbent water company and may include the developer itself. NAVs in contrast, are companies appointed by Ofwat who as well as being able to provide the developer services works for a new development, can also go on to serve final end-user consumers as the monopoly provider for a defined geographic area instead of the local incumbent company. If the work is completed by an SLP or the developer, the assets are adopted by the local water company (incumbent water company or NAV) on completion.<sup>22</sup>

A breakdown of the minimum level of contestable activities available for SLPs was published in recent guidance related to the adoption of self-laid assets by water companies in England (“annual contestability summary”) and is presented in Appendix B for completeness. Each incumbent must publish an annual contestability summary every

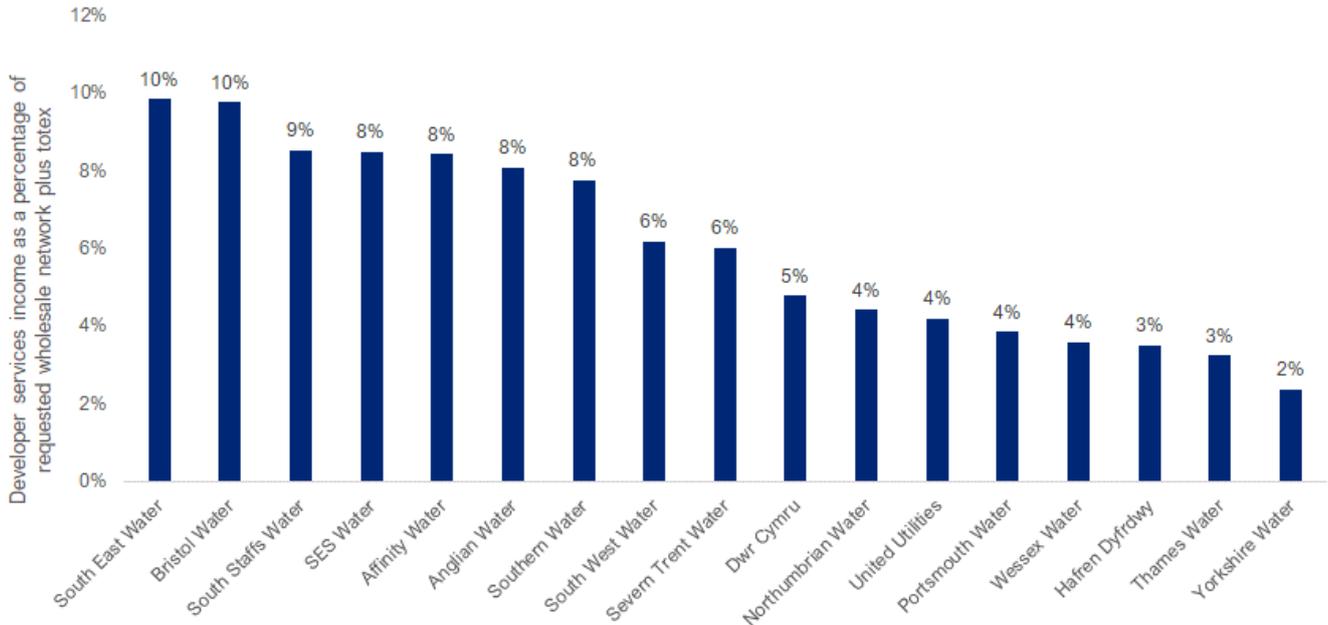
<sup>21</sup> We note that not all developer services are contestable, as discussed further below.

<sup>22</sup> No payments are made by the incumbent or NAV on adoption of the asset laid by the SLP.

year, which sets out the activities it considers to be contestable in its area of appointment. As a result, exactly which developer services are contestable can vary by company area (see Section 3).

For incumbent companies, while developer services are an important consumer facing part of their wholesale water and wastewater businesses, the services are part of a much wider portfolio of network utility related activities, with the level of expenditure linked, amongst other factors, to the volume of new connections activity expected within their local supply area. As illustrated in Figure 2.1 below, in PR19 business plans the incumbents forecast that developer services income over the duration of the price control would be in the range 2% to 10% of requested wholesale network plus operating and capital expenditure (i.e., totex).

Figure 2.1: Developer services income as a percentage of requested wholesale network plus totex



Source: CEPA analysis of Ofwat PR19 FD

## 2.2. REGULATION OF DEVELOPER SERVICES AT PR19

In this subsection, we explain the existing regulatory framework for developer services within Ofwat’s PR19 Final Determination.

### Treatment of developer services in the revenue control

Developer services are included in the wholesale water and wastewater network plus price controls set by Ofwat for PR19. This means that Ofwat sets overall revenue caps that companies must comply with which covers all wholesale water and waste network plus activities, including developer services.<sup>23</sup>

The network plus revenue cap comprises two sources of income: wholesale charges income, which are funded by the end customer base; and income from developer services charges, which are funded by developers (also known as grants and contributions (G&Cs)). Incumbents’ wholesale charges are set with a forecast of G&C income. If the developer services revenue is higher or lower than forecast, then incumbents will need to adjust their wholesale charges in order to comply with the overall network plus revenue cap. As a result, the overall price control operates as a ‘single till’, albeit with two sources of income.

The share of developer services costs that is recovered from developers and the end customer base (referred to as the ‘balance of charges’) is determined:

- Through the **definition of the ‘charging boundary’**, i.e., the works to which developer charges (G&Cs) are expected to contribute. Currently, developers in England pay for site specific and local reinforcement work.

<sup>23</sup> The network plus price controls includes wholesaler activities excluding upstream water resources and bioresources.

This means that developers pay towards direct developer services costs but not towards strategic network reinforcement costs (that may indirectly be caused by the new development).<sup>24 25</sup>

- Through the **deduction of an ‘income offset’** from the charges paid by developers, which is instead recovered from the end customer base.<sup>26</sup>

Ofwat are currently consulting on a number of possible changes to these arrangements as part of a consultation on possible options for the balance of charges in PR24.<sup>27</sup> However, currently the process for calculating developer charges for English companies can be summarised as follows:

- Incumbents determine developer services charges that reflect expected site-specific developer services costs (i.e., new connections, requisition and diversions charges) and local reinforcement requirements (i.e., infrastructure charge). Ofwat refer to this revenue as ‘gross’ G&Cs.
- Developer charges are then sometimes reduced with an ‘income offset’ in order to maintain the balance of charges between new and existing customers. The income offset is the only aspect of charges that does not need to be cost reflective.
- The income offset deduction is recovered from the end customer base through allowed wholesale network plus revenue (split between ‘pay as you go’ (PAYG) revenue and regulatory capital value (RCV) additions) to maintain the overall ‘balance of charges’.

To set the PR19 price controls, Ofwat used gross G&Cs (developer services *income*) as a proxy for developer services related costs, given the regulatory requirement for incumbents’ developer charges to be cost-reflective – that is, they are constructed to reflect the underlying costs of providing the service. This is reflected in Figure 2.1, which shows how developer services were treated in the calculation of the revenue control:

- First, gross G&Cs were deducted from gross network plus totex to calculate ‘net totex’ for cost sharing reconciliation through the price control’s totex cost sharing incentive mechanism.
- The income offset was then added in order to calculate net totex which was used to calculate PAYG revenue and RCV additions that form the building blocks for the allowed revenues incumbents were expected to recover from their wholesale charges.

In principle, this should mean that developer services are excluded from the totex cost sharing incentive mechanism for the network plus price control. However, if developer services charges do not equal the costs incurred then:

- Any under or over recovery of developer services costs will be captured in the cost sharing mechanism over the course of the price control.
- This means that a portion of underspend or overspend will be passed onto customers based on the incumbent’s cost sharing rates.

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<sup>24</sup> Developers in Wales may also contribute to wider / strategic network reinforcement through the infrastructure charge.

<sup>25</sup> Strategic reinforcement (as opposed to local reinforcement) associated with new developments is not charged to developers but is recovered through the end customer base.

<sup>26</sup> The income offset is applied to the infrastructure charge in England, to reduce some of the competitive disadvantage to NAVs. In Wales, the income offset is applied to the requisition charge. But Ofwat has consulted on changing this to the same approach as applied in England (source: <https://www.ofwat.gov.uk/consultation/consultation-on-new-connections-charging-rules-for-welsh-companies/>).

<sup>27</sup> Ofwat (April 2021): ‘A consultation on the scope and balance of developer charges and incentives’.

Figure 2.1: Calculation of net totex for the cost sharing reconciliation and PAYG calculations at PR19



Source: Ofwat, CEPA reformatted

## Setting an efficient ex-ante cost allowance

Within the framework set out in Figure 2.1, developer services costs were assessed by Ofwat with all other wholesale network plus base costs at PR19, i.e., on a gross totex basis.

Developer services were included in Ofwat’s Base Cost assessment, which comprised operating costs (opex), capital maintenance and growth-related expenditure across the range of activities in the network plus price controls. This meant that the costs were captured in the combination of econometric models that Ofwat used to benchmark Base Costs at PR19 and that used a selected set of explanatory variables for Base Costs as a whole.

However, the treatment of growth and developer services within the cost assessment was one area of the price review that received considerable consultation feedback and as a result Ofwat considered a number of different approaches and methodologies over the course of the price review. The approach applied in practice for the Final Determination (FD) was taken by Ofwat for several reasons:

- Developer services costs were not separately identifiable in the company data submissions (outturn and forecasts).<sup>28</sup>
- The integrated approach to Base Cost assessment mitigated for known reporting differences between operating, capital maintenance and growth-related expenditure.
- Limited information was available on possible drivers of developer services costs.

Further details on the approach to the cost assessment at PR19 is provided in the technical appendix on securing cost efficiency that accompanied the PR19 FD.<sup>29</sup>

The approach Ofwat adopted for developer services cost assessment at PR19 was considered a pragmatic methodology to capture the impact of developer services within the broader wholesale incumbent businesses. The Competition and Markets Authority (CMA) in its final determination for PR19 appeals was broadly supportive of Ofwat’s approach, given known data limitations and methodological issues.<sup>30</sup>

## Managing uncertainty and meeting customer needs and interests

The network plus price control includes a number of mechanisms to incentivise certain behaviours from incumbent companies and to manage uncertainty around developer services over the duration of the price control.

The revenue cap is subject to a revenue forecasting incentive (RFI) to incentivise accurate revenue forecasting and predictable and stable customer charges. Incumbents face a financial penalty of up to 3% of the revenue imbalance where differences between actual and allowed revenues are greater than 2%. The recovery of developer services income will as a result affect performance under the RFI.

In PR14, the amount of revenue incumbent companies were permitted to recover was not automatically adjusted for the volume of new connections. This meant an incumbent was not allowed to automatically recover additional

<sup>28</sup> Ofwat could have used grants and contributions as a proxy of developer services costs but this option was not taken forward.

<sup>29</sup> Ofwat (Dec 2019): ‘PR19 final determinations: Securing cost efficiency technical appendix’.

<sup>30</sup> CMA, 2021. Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations. Final report. Available [here](#).

revenue if outturn new connections were higher than forecast at the time of the price review. Ofwat considered this may have created a disincentive on companies to provide new connections in a timely manner.

In response, Ofwat introduced the Developer Services Revenue Adjustment (DSRA) mechanism at PR19 to encourage timely new connections. The mechanism will (symmetrically) adjust revenues at the start of PR24 based on the difference between outturn and forecast total number of properties connected during the 2020-25 period using an average unit rate for a property unique for each company.<sup>31</sup> Hence the DSRA mechanism protects incumbents from volume risk (differences between forecast and outturn connections made) and market share risk (i.e., decrease in revenues from losing work to SLPs even if the total outturn volume of new connections is consistent with forecasts at the price review). This is an incentive for incumbents to actively facilitate development of the market.<sup>32</sup>

Deviations of developer services expenditure from forecast for reasons other than 'volume' and 'market share' are not mitigated through the regulatory framework because developer services costs are excluded from totex cost sharing (assuming developer services revenue is a good reflection of developer services costs – see above). Hence, incumbents bear the risks associated with the mix of work and unit costs.

Overall, the PR19 regulatory framework incentivises incumbents to increase the proportion of work conducted by SLP given they are revenue neutral to the party who delivers developer services. In order to support this revenue neutrality, *customers* collectively may incur the costs of a new development both through connection charges levied by an SLP and (implicitly) in the incumbent's allowed revenue requirement.

At PR19, Ofwat also introduced the Developer Services Measure of Experience (D-MeX) to incentivise companies to improve the contestable and non-contestable services they provide to property developers, SLPs and NAVs. D-MeX is a performance incentive that comprises a single score for each company, based on two components:

- **Qualitative**, which includes a satisfaction survey of developer services customers.
- **Quantitative**, which measures company performance against key performance metrics.

Each company can receive outperformance payments or incur underperformance payments based on its annual D-MeX scores compared with other companies. Companies that score above the median company score will receive standard outperformance payments for that year up to 6% of that year's annual actual developer services revenue. Companies that score below the median company will score underperformance payments of up to 12%.

In addition to D-MeX, English incumbent water companies are regulated by a Code for Adoption Agreements, to smooth and standardise the process of incumbents adopting assets which are laid by developers and SLPs and more broadly to assist in facilitating development of the market.<sup>33</sup> Ofwat expects these documents to drive a better developer services customer experience, which in turn will support a level playing field for developer services customers who wish to apply for and enter into adoption agreements.

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<sup>31</sup> This leads to some timing issues given the RFI is applied annually but will not reflect allowed revenue adjustments made through the DSRA. This could lead to some bill volatility for existing customers.

<sup>32</sup> Under their price control, incumbents are revenue neutral to the provider of the new connection, i.e., incumbent, SLP or NAV. This means that they can outperform the price control cost targets depending on the supply route, given that they receive the same revenues, but do not necessarily incur the costs in a scenario where the SLP or NAV provides the new connection.

<sup>33</sup> Source: <https://www.ofwat.gov.uk/regulated-companies/markets/connections-market/code-adoption-agreements/>.

### 3. KEY ISSUES FOR PR24 AND BEYOND

Having set out the approach to the regulation of developer services established at PR19, in this section we explore key issues and questions that Ofwat will need to consider looking forward to PR24 and beyond as it implements its strategy and approach to developer services regulation.

To identify these key issues and questions:

- We held a series of interviews with stakeholders in the sector, including incumbent companies and SLPs. As discussed in Section 1, we also held an industry workshop which was used as an opportunity to gather further views on the key issues for PR24.
- We have taken into consideration the recent conclusions of Ofwat's project RISE that amongst several topics highlighted the growth, but also differences, in the development of markets for developer services in different incumbent areas across the country.<sup>34</sup>
- We have reviewed the current approach to regulation from a regulatory economics perspective – i.e., in terms of the effects (e.g., incentives and risks) that the system creates for incumbents, but also how this may influence the effectiveness of competition in contestable developer services.

We have grouped the discussion into two themes:

1. The **status of competition in contestable developer services**, where we cover high level information on the current and future prospects for competition across different segments of contestable developer services (e.g., large and small developments).
2. The **performance of the current approach to incumbent company regulation**, in terms of the regulatory protection this provides consumers, the incentives and risks the system creates for incumbents, and the perceived burden/complexity of the regulation.

Finally, we ask the question whether a 'do nothing' approach (i.e., a strategy that retains the PR19 approach as the starting point for PR24) is likely to be appropriate given the range of issues identified.

#### 3.1. COMPETITION IN CONTESTABLE DEVELOPER SERVICES

For the reasons set out in the introduction, we have not undertaken a full market study of competition in developer services in the water sector. The high-level information and range of informal stakeholder feedback on the state of competition in developer services which we set out below, has nevertheless informed our study and the options development process in later sections of the report.

Ofwat's review of incumbent company support for markets in the water sector, including developer services, highlighted substantial differences across England.<sup>35 36</sup> More specifically, the study highlighted there are more active SLPs/NAVs in some parts of England than others, which as discussed below, may suggest the presence of various local/regional developer services markets. These regional differences mean it is challenging to assess how effectively developer services markets are functioning overall, alongside the fact there is limited data on the state of competition across different market segments in developer services. We have engaged with incumbent companies, SLPs and NAVs to better understand what may be driving these regional differences.

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<sup>34</sup> Ofwat (2020), 'Review of incumbent company support for effective markets', available [here](#).

<sup>35</sup> Ibid. see Section 4, p. 30 – 41.

<sup>36</sup> SLPs can operate in Wales but we understand that the current level of activity is low hence we have focused on English water companies. It is important to be mindful that water companies whose areas are wholly or mainly in Wales have a different developer services charging framework to English water companies and that developer services is a devolved issue for the Welsh Government.

## There is significant regional variation in SLP/NAV market penetration

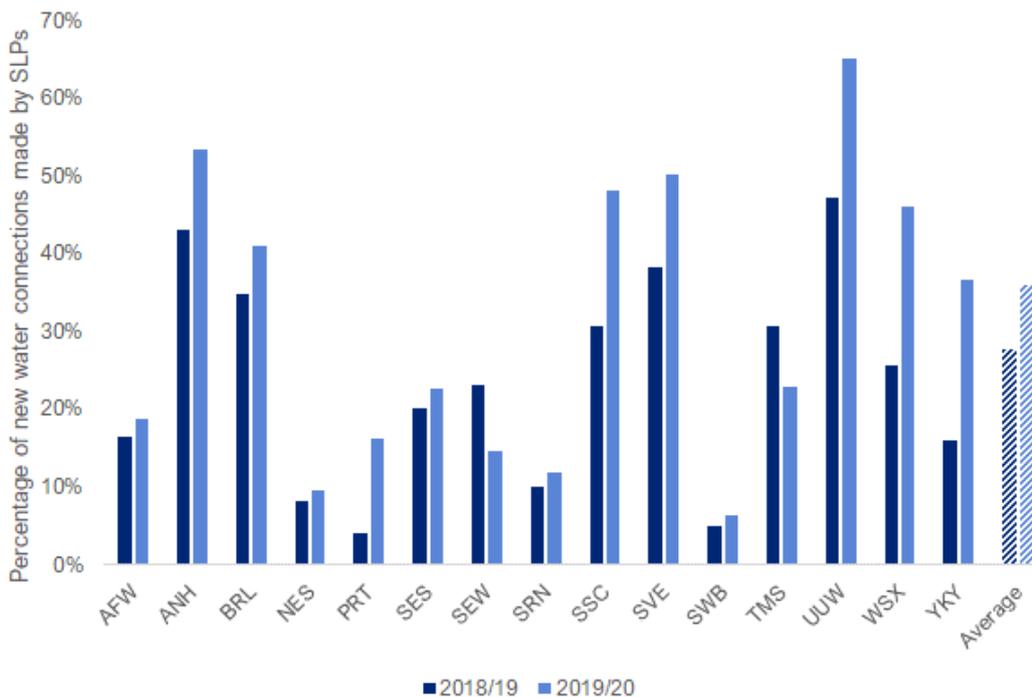
There are currently 209 accredited SLPs according to Lloyd’s Register;<sup>37</sup> and 9 new appointees serve around 196 sites.<sup>38</sup> At face value, this suggests that there is many developer services providers operating in the market, which should facilitate a sufficiently rivalrous process of competition for contestable developer services business.

However, stakeholder feedback has highlighted that there are regional differences in the number of active SLPs/NAVs, and different segments of the market are typically more contestable than others (e.g., SLPs are typically more interested in large rather than smaller ‘infill’ developments). A higher degree of market penetration by SLPs or NAVs in a given operating area may be associated with a better functioning market, but that may still mask considerable variation in the degree of contestability for different types of new developments.

We have been told that SLPs often operate regionally rather than on a country-wide basis, in order to develop a good client relationship with the developer/connecting customer and because of differences in the level of new connections activity across incumbent water company operating areas. This leads to fragmented local/regional developer services markets, some of which have considerably more active SLPs than others. This was also found in Ofwat’s project RISE, which found that the proportion of water new connections made by SLPs varies considerably across companies, ranging from 4% (Portsmouth Water) to 47% (United Utilities) in 2018/19. This suggests that from a supply side perspective, markets in contestable developer services are local.

Data from 2019/20 presents a similar message, with the proportion of water new connections made by SLPs ranging from 6% (South West Water) to 65% (United Utilities) although SLP market shares in some company areas have increased substantially between 2018/19 and 2019/20, as the figure below shows.<sup>39</sup> This has led to the industry average proportion of new connections made by SLPs increasing from 28% in 2018/19 to 36% in 2019/20, which indicates that the level of competitive pressure in local developer services markets may be increasing.

Figure 3.1: Proportion of new connections made by SLPs in 2018/19 and 2019/20



Source: Ofwat

<sup>37</sup> Available at <https://www.lr.org/en/utilities/water-industry-registration-scheme-wirs-wirsae/search/> (accessed 22/04/2021).

<sup>38</sup> Ofwat, ‘Register of new appointments and variations granted to date’, available at <https://www.ofwat.gov.uk/publication/register-of-new-appointments-and-variations-granted-to-date/> (accessed 18/05/2021). Excluding variations granted to incumbent water companies.

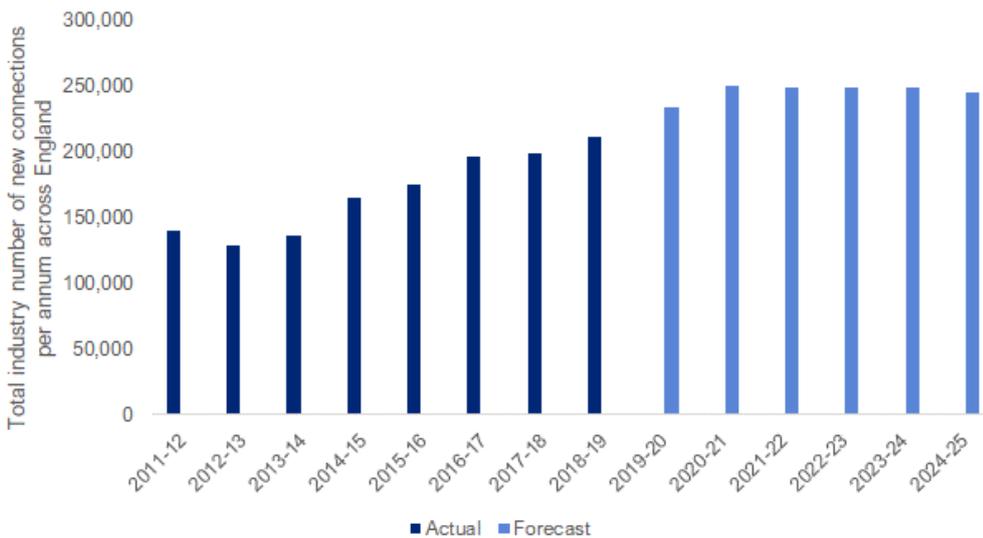
<sup>39</sup> Data on new connections made by NAVs are not readily available at present. Although some stakeholders indicated that NAVs are more prominent in the South of England and SLPs are more prominent in the North of England.

The significant regional variation in supply penetration of SLPs and NAVs is likely to continue to influence the degree to which developers/customers in certain incumbent areas may benefit from competing quotes in local developer services markets. However, this may depend on the expected types and sizes of new developments in the local area, given that stakeholders indicated that larger developments, typically involving new infrastructure, are also typically subject to much greater competition. Consumers in some parts of the country and with certain types of new development (e.g., smaller infill works) may instead be considerably more reliant on their incumbent water company for developer services than consumers in other parts of the country.

**There is growing demand for developer services but also regional variation**

From a demand side perspective, the volume of new connections activity has gradually increased in England in recent years, as shown in the figure below, increasing from around 128,000 new connections per annum in 2012/13 to around 210,000 new connections per annum in 2018/19.<sup>40</sup>

Figure 3.2: Total new water connections across England, 2011/12 to 2024/25, actual and forecast



Source: Ofwat PR19 Final Determination, historical actuals and company forecasts

The incumbent companies’ PR19 business plan forecasts suggest the number of new connections per annum will continue to increase up to 2020/21 before stabilising for the rest of the PR19 period.<sup>41</sup> This should encourage SLP and NAV investment in developer services and help to increase the effectiveness of local markets.

Drilling down to company level, however, exposes considerable variation across incumbent companies’ supply areas. The level of new connections activity differs substantially across incumbent water companies, which is likely to reflect the relative size of each company’s operating area and the relative size of developer activity (itself driven by external factors such as population growth, economic growth and regeneration) within each area. This is shown in Figure 3.3, which illustrates that new connections activity is forecast to be relatively high in the areas served by Thames Water, Anglian Water, United Utilities and Severn Trent Water.

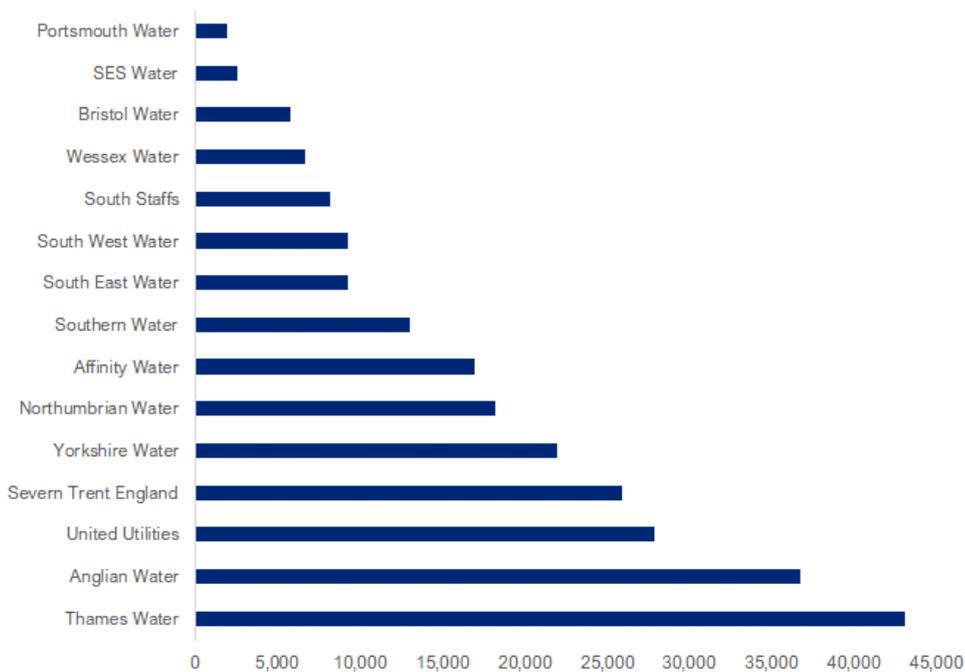
One implication of this is that differences in the pipeline of new connections and developments across England are likely to be more or less conducive to new entrant ‘investment’ in developer services, which may partially explain the variations in SLP market penetration shown in Figure 3.1 above.

This was reflected in stakeholder feedback we received, which suggested that SLPs set up regional hubs in areas where there is sufficient demand (i.e., close to large developments). As a result, areas of the country that are not attractive to large developers (e.g., relatively low demand for new housing and/or smaller developments) may not be attractive to SLPs and NAVs.

<sup>40</sup> Source: <https://www.ofwat.gov.uk/final-determinations-models/>.

<sup>41</sup> Company forecasts were submitted alongside their PR19 business plans and were made before the impact of Covid-19 was fully understood or felt – companies report that connections activity is down because of Covid-19.

Figure 3.3: Forecast annual number of new water connections by company, 2020/21 to 2024/25 average



Source: Ofwat PR19 Final Determination, company forecasts

Another theme that was highlighted during our industry workshop was the expectation that suppliers of developer services will need to be flexible to accommodate diversity and complexity in new connections. The Oxford/Cambridge development arc was provided as an example of this (i.e., very large new developments) as well as modern construction methods and sustainable solutions. Where external factors may result in material deviations from forecast during the price control, a degree of flexibility in the regulatory framework is likely to be beneficial.

### The degree of competition varies between market segments

Developer services are not a single “market”, but a varied set of developments that may include individual or groups of connections, mains connections, network reinforcement and diversions. Stakeholder feedback has suggested that the degree of competition varies between these different market segments.

For example, as noted above, large developments can attract considerably more attention from SLPs and NAVs as this is where they can earn economies of scale and scope. In contrast, smaller developments or connecting individual properties to the existing network (‘infill development’) may be less attractive, meaning that the incumbent water company may be the only available option for the developer/connecting customer.

The scope for competition may also vary depending on SLPs’ and NAVs’ capacity to differentiate themselves from incumbent companies. For example, stakeholder feedback highlighted that:

- SLPs can often install multiple utilities and fit in better with the new development construction programme, which may be beneficial to developers (i.e., economies of scale and scope).
- NAVs may also be able to be more flexible to the developer’s requirements than the incumbent and may also offer greater flexibility and innovation in infrastructure provision.<sup>42</sup>

These are further reasons to believe that the effectiveness and degree of competition in developer services markets differs substantially between market segments and across the country. Again, this would imply:

- Many customers may continue to be reliant on the incumbent as their supplier in PR24 and future price control periods.

<sup>42</sup> Including providing and maintaining sustainable drainage systems that incumbents can be unwilling to adopt, See Ofwat (2020), ‘Review of incumbent company support for effective markets’, p. 31.

- Even if SLPs or NAVs are particularly active in an incumbent area, this does not guarantee there will always be significant competition for the new development works.

## **Customers are not always engaged in markets for developer services**

Stakeholder feedback has also suggested that many developers may not be familiar with the self-lay route and its benefits. This was highlighted as a particular issue given it was considered that some incumbents are more proactive than others at raising awareness of the potential benefits of SLPs/NAVs to developers.

While Ofwat has put in place a series of measures to improve developer awareness and ability to engage in developer services markets – including activities that incumbent companies can take to support effective markets (see below) – some of these issues are likely to persist leading into PR24. This raises the question whether further measures and incentives are needed to continue to support new entrant participation in a range of developer services market segments, and to support developers more actively considering the SLP route.

## **Incumbents' role in promoting developer services markets**

One of the issues raised in Ofwat's conclusions to project RISE was the important role that it expected incumbents to play in *promoting* effective markets for developer services.<sup>43</sup>

While Ofwat concluded that some companies within the industry were taking a very active role in promoting developer services markets, it also concluded there was room for improvement across the industry and that real differences existed between and within companies in certain areas of performance.

Points that were raised during our stakeholder engagement on this theme were as follows:

- There continues to be a debate within the water sector around incumbents' setting of cost reflective developer services charges. This includes the treatment of overheads, the appropriate approach to take under different incumbent operating models for their developer services (e.g., in-house, or outsourced) and the appropriate balance between developer charges and end customer charges.<sup>44</sup>
- Some stakeholders also stated that they would like incumbents to go further in terms of the consistency/comparability and transparency of their charging arrangements and processes for developer services. For example, some stakeholders suggested more prescriptive rules and regulations on the processes and information provision on developer services.

A number of stakeholders suggested that these issues might be addressed if there were greater transparency of incumbents' total developer services related costs, to demonstrate that charges reflect the costs likely to be incurred by incumbents in the delivery of developer services.

The current regulatory framework has measures to encourage incumbents to play an active role in promoting developer services markets and to address some of the issues identified above. For example:

- Feedback from stakeholders has indicated that the introduction of D-MeX has had a positive impact on the quality of service provided by the incumbents to developers, SLPs and NAVs, since its introduction.
- Developer services remains a relatively low proportion of network plus revenue, and D-MeX has increased the focus of the incumbents on the delivery of developer services and market facilitation.<sup>45</sup>
- The Code for Adoption Agreements set a minimum service standard that incumbents in England are now expected to meet when delivering developer services and responding to SLP/NAV queries, and the consequences that follow if they fail to meet this standard.

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<sup>43</sup> And other parts of the value chain.

<sup>44</sup> An issue currently under consultation by Ofwat. See "[A consultation on the scope and balance of developer charges and incentives - Ofwat](#)", April 2021.

<sup>45</sup> For example, via positive engagement activities with SLPs and NAVs.

SLPs provided feedback that there are material differences in the incumbents' approaches to market engagement around developer services. They indicated that some incumbents embrace the SLPs/NAVs operating in their area whereas others opt to keep them at arm's length with an 'us versus them' attitude to the working relationship.

Incumbent company size can also impact engagement with developers, SLPs and NAVs. For example:

- larger water and wastewater companies, with greater resources, often have individuals who are dedicated to looking after SLPs and NAVs; whereas
- smaller incumbent companies may only have a handful of individuals that respond to all developer services customers.

One suggestion made by several stakeholders during our engagement was that a guaranteed standards scheme could be introduced in relation to developer services, akin to the scheme in place for electricity new connections which is enabled by secondary legislation.<sup>46</sup> While this has similarities to the redress scheme that is part of the Code for Adoption Agreements that Ofwat has already put in place,<sup>47</sup> the general insight was that the more guaranteed standards there are in place for incumbents the more this will force them to 'set a marker' for all providers in the sector of the standards that developers should expect to receive.

One incumbent suggested that the quality of service provided by its developer services team to developers is so good that developers often do not even engage with the possibility of using an SLP or NAV to deliver the new connection services. This emphasises the importance of assessing the performance of the developer services market based on a wide range of information, including the quality of service provided to developers by market participants. For example, one hypothesis could be that SLP/NAV market shares are low in some parts of England because the incumbent already offers a competitive price and a good quality of service which the SLPs and NAVs operating in that area feel they cannot compete with.<sup>48</sup>

Overall, we believe a key question that Ofwat needs to consider at PR24 and beyond, is what role should incumbents play in developer services? Aspects of incumbent companies' operations can serve to facilitate, support and even promote SLPs and NAVs, whether through information provision or delivery of the essential upstream elements of new connections services that only incumbents can provide. Incumbents can also compete directly against SLPs and NAVs for market share – subject to not abusing their market position.

These two roles are not mutually exclusive, but Ofwat's approach to regulation may influence the direct financial incentives at play. The current system of regulation, under which incumbent companies are largely protected from loss of market share, emphasises the incumbents' market development role. Incumbents are not currently rewarded in proportion to their market share, which limits their financial incentive to compete with SLPs and NAVs on service quality or price. More active competition between incumbents and SLPs and NAVs may be in the long-term interests of consumers – but financially incentivising incumbents to grow market share would introduce a source of tension with their market development role.

## **Incumbents' role as a SoLR in developer services markets**

Stakeholder engagement, in particular with incumbent companies, also raised the role that incumbents play as the Supplier of Last Resort (SoLR) in the developer services market.

This is a necessary role in a sector where developers and customers are given a right to connect to the existing water network and incumbents have a duty to connect new properties to their networks. Given that SLPs and NAVs have tended to focus on particular market segments, the SoLR role is particularly important for certain developments where there are none or only a small number of alternative offers from different suppliers.

Incumbents suggested that the treatment of revenues and costs for developer services in PR19 could in future expose them to cost recovery risks, in part linked to this SoLR role. It was suggested that increasing market penetration by SLPs and NAVs could leave incumbent companies with an obligation to undertake the more

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<sup>46</sup> See 'The Electricity (Connection Standards of Performance) Regulations 2015', available [here](#).

<sup>47</sup> Which might reduce the benefits that could be achieved in practice from an additional guaranteed standards scheme.

<sup>48</sup> See subsection on regional variation in SLP penetration above for more detail.

costly/less attractive new developments, but that the aggregated assessment and benchmarking of their developer services costs as Base Costs at the time of the price review may:

- not adequately capture this impact on companies' efficiently incurred costs;
- increase the risk that incumbents are exposed to risks from the 'mix of work' assumptions embedded in setting cost allowances at price review; and
- penalise those companies that facilitate high penetration of SLPs and NAVs.<sup>49</sup>

We discuss stakeholders' views on these issues further in Section 3.2 below.

## Implications for PR24 and beyond

Given the status of competition in markets for developer services across England<sup>50</sup>, the approach to regulation in PR24 is likely to need to balance use of markets and regulatory tools (e.g., via some restrictions on incumbents' charges) to achieve effective outcomes for all consumer groups, particularly those customers who cannot access offers from a range of developer services suppliers. The question is what form of regulation is most appropriate and would help put the sector on the most effective direction in the longer term; for example, being able to place greater reliance on market outcomes rather than price control regulation.

We have discussed above how in some market segments and regions of England, local incumbents face very active competitive pressure from SLPs or NAVs. But stakeholder engagement also indicates that the level of competition may be far greater for some market segments than others, as certain development types are typically more attractive to SLPs and NAVs. This might suggest that the approach to developer services regulation established at PR24 needs to be more flexible and dynamic to the supply and demand conditions of different contestable developer services market segments observed across the country. This may help to:

- create a less burdensome regulatory approach, if greater reliance can be placed on competition to deliver effective outcomes for consumers; and
- looking beyond PR24, allow the regulation to be more easily adapted by Ofwat if and when stronger evidence of competition in individual market segments is observed.

Any future system of regulation also needs to consider the balance of incentives on incumbent companies to:

- actively support the SLP/NAV supply route (as the current regulation incentivises); or
- compete with SLPs and NAVs as actively as possible for market share.

Depending on the objective sought, this may require the approach to the regulation of developer services to take quite a different direction over time.

Finally, we have discussed how incumbents also currently play the role as the 'SoLR' for developer services. The SoLR role ensures that developers/consumers can get connected, but it potentially also creates issues for the regulatory framework. For PR24, we think this issue is linked with identifying the best system of regulation going forward that will enable incumbent companies to be able to expect to recover their *efficient* costs, where there is a potentially quite different levels of SLP and NAV penetration and other drivers of developer services costs across the incumbents' local supply areas. Looking beyond PR24, Ofwat might also ask whether there is an opportunity to consider whether alternative regulatory arrangements could ensure that all customers can receive a connection to the network. For example:

- Could Ofwat require SLPs to sign up to be a SoLR as a condition of being allowed to compete more generally in the market? Or

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<sup>49</sup> In conflict with a regulatory objective for incumbents to support developer services markets. This might arise if they are left carrying fixed (e.g., overhead costs) but low levels of developer services activities.

<sup>50</sup> The treatment of developer services in Wales is different to England, and so we have focused our review on developer services in England. Any changes in the regulatory framework at PR24 will need to take into account the circumstances of Welsh as well as English water and sewerage companies.

- Could a regulatory process be developed, where customers that fail to receive a competitive offer could seek an intervention from Ofwat to appoint a SoLR?<sup>51</sup>

### 3.2. ISSUES WITH THE CURRENT APPROACH TO DEVELOPER SERVICES REGULATION

In this subsection, we consider the issues with the current ('PR19') approach to developer services regulation that stakeholders have highlighted to us during the course of the assignment. In light of the issues, we consider whether a 'do-nothing' option – i.e., a decision to apply the same regulatory approach to developer services in the wholesale network plus control as at PR19 – should be considered an option by Ofwat for PR24.

#### **The current regulatory approach allows Ofwat to take a proactive approach to developer services regulation and consumer protection. Stakeholders, however, find the approach to regulation complex.**

Under the current framework, Ofwat can proactively set the direction of the developer services market, through the price control, financial incentives, and charging rules. Ofwat has the ability to determine costs and revenues and to intervene to promote customers' interests. It also provides flexibility to adapt the regime over time to focus on new objectives. For example:

- At PR19, Ofwat was able to adapt the regime from PR14 to better incentivise incumbents to deliver new connections and facilitate alternative supply routes via the design of the DSRA.
- At PR24, Ofwat has already set out the challenges it plans to address, e.g., around supporting public value and the environment amongst a range of other objectives.

A proactive, e.g., price control based, approach to developer services regulation could allow Ofwat to:

- introduce new incentives or regulations for incumbents to promote better environment outcomes (e.g., in the design of new development works); and/or
- adapt the funding settlement and existing performance mechanisms (e.g., D-MeX) to allow companies to focus on promoting public value as part of the local role in facilitating and delivering developer services.

The proactive approach to regulation of developer services within the network plus price controls, however, comes at the cost of increased complexity:

- The current framework consists of many interacting components with varying incentives, which incumbents said they find difficult to comprehend holistically and comply with effectively.
- The single till mechanism can also contribute to bill volatility as end customer wholesale charges need to be adapted to comply with the overall revenue cap for the price control.

In our engagement with incumbents, they identified the complexity of the current approach to price control regulation of developer services as the most material regulatory issue. Other stakeholders also raised the complexity of regulation as an issue, but in relation to a broader set of factors than solely the price control.<sup>52</sup>

Tackling complexity is intrinsically linked to other issues. In particular, improving the existing regulatory approach while retaining developer services within the network plus price control may add rather than remove complexity.

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<sup>51</sup> Which might not necessarily need to be the local incumbent water company. For example, even if the local incumbent has exited the developer services market, there may be neighbouring water companies who could be appointed by Ofwat to provide then connection, should a competitive market offer not be forthcoming. How to mitigate the risk developers do not seek to actively participate in the market, and instead rely on a SoLR process, would need to be considered with such an approach.

<sup>52</sup> For example, around existing developer services charging rules and policies, e.g., the income offset, as well as the broader price control regulatory framework.

Other elements of the existing regulatory framework, such as the application of the 'income offset', were also highlighted as a component of the existing regulation that can add considerable complexity.<sup>53</sup>

## **Treatment of revenues creates a direct financial incentive for incumbents to promote the SLP route to developers but also encourages incumbents to operate the services as a cost rather than profit centre**

As discussed in Section 2, incumbents are currently incentivised to encourage SLPs to provide developer services. The DSRA mechanism means that allowed revenues an incumbent does not recover from developers can instead be recovered from the company's end customer base.

This creates a direct incentive for incumbents to promote the alternative supply route to developers<sup>54</sup> which may be beneficial in encouraging incumbents to address factors that may act as an impediment to developers choosing an alternative supply route and support market entry within their local supply areas. However, this also adds to the cost of maintaining competition. The developer pays the SLP for the new development, while the incumbent is still entitled to a level of allowed revenue under the DSRA for a given number of new connected properties.

Incumbents are also required to set cost reflective developer services charges and, overall under the terms of the revenue cap, are only entitled to earn a cost of capital on the portfolio of network plus activities that comprise the wholesale network plus RCV. This means that incumbents are not permitted to earn any additional profit simply from delivering developer services related work, although along with other components of the network plus price controls, additional profits may be made from outperformance of the regulatory settlement.

There are a number of possible effects of this approach to regulating profits:

- The structure of the price control may encourage incumbents to run developer services as more of a 'cost centre' (via reactive operations and 'working to budget') than as 'profit centre' where greater margin can be earned from winning new business.<sup>55</sup> The incentives on incumbents are limited to the regulatory incentives created via the network plus price controls (e.g., D-MeX).

This is not necessarily reflective of how a standalone developer services business (e.g., SLP) would operate in a well-functioning competitive market (i.e., to compete with new service offerings and cost reductions to achieve a greater market share and earn an additional profit from contested services).

- The treatment of profits from developer services within the network plus price control could in principle restrict the ability of SLPs and NAVs to compete effectively with the incumbents, in circumstances where the incumbents' developer services charges do not adequately reflect the opportunity costs of capital that SLPs and NAVs themselves may incur in the delivery of developer services.

While this may be an issue in principle, our engagement with stakeholders did not identify the level of incumbents existing charges as a fundamental barrier to competition in developer services. Depending on the delivery model adopted by incumbent companies, developer services charges can include a provision for 'contractor margin' separate to the treatment of profits in incumbents' price controls which can provide the necessary 'headroom' to encourage competition from other providers.<sup>56</sup>

Nevertheless, there is the risk that the current system of regulation *could* act as a barrier to competition from the treatment of the opportunity costs of capital. In Appendix A we set out the experience of regulating new connection services in other utilities sectors, in particular, gas and electricity. One of the motivations, that appears to have led Ofgem to remove contestable new connection services from electricity distribution

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<sup>53</sup> We note that Ofwat is currently consulting on removing the income offset at PR24. See Ofwat (April 2021): 'A consultation on the scope and balance of developer charges and incentives'.

<sup>54</sup> The incumbent is effectively not profit neutral to the supply route chosen by the developer.

<sup>55</sup> e.g., via finding cost savings or seeking innovations in service offerings.

<sup>56</sup> We also note that incumbents are required to set cost reflective developer services charges, which may not necessarily restrict them from including their own margin in their charges if an opportunity cost is incurred. Overall, however, incumbents are still constrained by the revenue cap set by Ofwat for wholesale network plus services.

network operators (DNOs) price controls at the DPCR5 price review, was to address a perceived issue that existing connection charges did not always provide sufficient 'headroom' to support competition.

## **The treatment of developer service costs at PR19 has been raised as an issue**

As discussed in Section 2 and 3.1 above, at PR19, developer services costs were assessed and benchmarked as part of wholesale network plus base costs.

A number of stakeholders at the time of the price review challenged that this approach did not in their view allow for appropriate cost recovery as the wholesale base cost econometric models did not account for important drivers of developer services costs. Examples of developer services cost drivers in addition to the volume of new connections and length of new mains may include:

- **Length of communication pipe**, which could be proxied by property type. A high proportion of new connections that are flats will lead to lower per property communication pipe requirements.
- **Development site ground surface**. Hard surfaces can lead to higher new connection costs. But incumbent costs can be reduced if developers take on the responsibility of digging trenches and reinstatement.
- **Remoteness of development sites**. All else being equal, a new development located far away from existing infrastructure is more likely to require reinforcement.

Some stakeholders also consider that developer services cost information was not used as effectively as it could have been at PR19. For example, the incumbents collect substantial data to develop their developer services charges each year, but this was not used by Ofwat within the cost assessment process.

Although the CMA was largely supportive of Ofwat's approach to assessing costs associated with new developments at PR19 this would suggest that there are potentially opportunities to improve the approach to cost assessment and the treatment of developer services costs at future price reviews.

The SoLR role combined with increasing (but variable) SLP and NAV penetration presents cost assessment challenges. It may result in incumbents needing to spread the overhead cost of running an active developer services unit within their wider businesses over a smaller volume of new development activity. In addition, the more aggregated the assessment of incumbents' developer services costs, the more difficult it becomes to account for differences in the mix of developments each incumbent may need to deliver.

While in principle, some of these issues might be addressed via company-specific adjustments within the cost assessment,<sup>57</sup> they help to highlight some of the challenges of setting price controls for developer services activities within a much broader wholesale network plus control.

## **The treatment of developer services within the price control protects incumbents from certain risks but also exposes them to others**

There are a number of risks in principle for incumbents in the provision of developer services (see Table 3.1). These are under the control of companies to different degrees, and the existing form of regulation influences the degree to which companies are also exposed to these risks.

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<sup>57</sup> Cost adjustment claims are mechanisms for a company to present evidence of unique operating circumstances, legal requirements or atypical expenditure which drive higher efficient costs for the company relative to its peers.

Table 3.1: Incumbent risks in the provision of developer services

Risk	Definition	Controllability
Volume risk	Overall volume of new connections varies from forecast, e.g., at the time of the price control or charge setting.	Non-controllable
Market share risk	Volume of work undertaken varies from forecast, which may affect companies' ability to recover fixed overheads.	Partially controllable
Unit cost risk	The cost of delivering the work is higher or lower than expected (for example due to changes in underlying input prices) or is contingent on an efficiency assessment under the price control.	Partially controllable
Mix effects risk	As SLP and NAV market penetration increases, incumbents may be left with more complex / expensive work.	Mostly non-controllable

Source: CEPA

The allocation of these risks in the current regulatory framework can be summarised as follows:

- **Volume risk** is currently mitigated through the application of the DSRA mechanism, recognising that the volume of new connections is driven by demand factors and is therefore mostly outside of incumbent companies' control.
- **Market risk** is also mitigated through the DSRA, as it does not differentiate between new connections made by the incumbent or SLP. As discussed above, this offers an incentive for incumbents to facilitate SLPs in the market.
- **Unit cost risk.** Whether incumbents are (partly) protected from this risk depends on the timing of any cost changes.
  - As discussed above, the totex sharing mechanism applies to price control totex net of G&Cs. With the assumption of cost-reflective charging, any cost changes that are known prior to each year's charges being set should be fully reflected in G&Cs. Incumbents would therefore not be protected from this risk – except insofar as inaccuracies in setting cost-reflective charges provide mitigation.
  - However, any cost changes that arise during a charging year would not be reflected in that year's G&Cs. This may allow incumbents a degree of protection.
- **Mix of work risk**, was frequently raised as an issue in our engagement with incumbents, who highlighted that they could end up delivering more complex work than was originally forecast if SLP/NAV penetration increases. A number of incumbents suggested that it is not appropriate that they were exposed to mix of work risks, given their SoLR roles.

Naturally, incumbents receive greater protection from cost recovery risk under a price-controlled framework than if elements of developer services were excluded from the price control. If developer services remain a price-controlled activity at PR24 and beyond, Ofwat might want to consider capturing mix of work effects within the DSRA, although this would also add further complexity to the existing regulatory approach.

However, while it might seem that the regulatory ideal might be to account for all factors that impact companies' relative costs and to design a regime that addresses all risks in increasingly as "complete" a way as possible, such an ideal may not be achievable or desirable in practice. Incumbent companies benefit from economies of scale and scope from the integration of a range of wholesale business activities. While the PR19 regulatory system may expose companies to certain risks within the specific developer services component of their businesses, it is also feasible that, in the round, these factors may be compensated elsewhere within the wider scope of the network plus price control where other parts of the framework are also not perfectly targeted and complete.

As a matter of practice, the fact that incumbents face a set of risks from the treatment of developer services does not necessarily mean that the regulatory system is a problem.

### 3.3. SHOULD THE STATUS QUO BE THE STARTING POINT FOR PR24?

The stakeholder feedback received, and the findings from the Ofwat's project RISE, would indicate that looking forward to PR24 and beyond, any approach to developer services regulation will need:

- To promote effective markets, in particular, ensuring that incumbents have the right incentives and obligations to facilitate competition in this area of the sector.
- Measures that offer protections for consumers, given the state of competition in developer services market segments varies considerably between incumbent areas and within different market segments.

There are a range of issues with the approach to regulating developer services at PR19. In particular, its complexity, its treatment of costs and revenues, and the risks and incentives to which it exposes incumbents to.

Despite these issues there are reasons to pause before necessarily seeking a major change to the current regulation. The existing approach incorporates components that promote diversity in the supply base while protecting consumers via the network plus price control. Regulation of developer services is on an improving trajectory: a range of recent interventions by Ofwat – Code for Adoption Agreements, project RISE, guidance ahead of incumbents developing their 2021/22 charging arrangements and introduction of D-Mex – may take effect and address some of issues identified above. Finally, the materiality of any issues identified in relation to developer services would need to be weighed against the costs of addressing them, including the opportunity cost in terms of Ofwat's priorities for PR24.<sup>58</sup>

On balance, however, we consider a 'do-nothing' option – i.e., a decision to simply apply the same regulatory approach and methodology to developer services in the wholesale network plus control as Ofwat applied at PR19 – should not be Ofwat's starting point for the PR24 price review:

- Recent trends suggest that competition in contestable developer services is increasing which might suggest that, even if not achievable in PR24, there is the prospect that Ofwat might over time rely more on the outcomes of markets than a more proactive regulatory approach via price control regulation.
- While the CMA was generally supportive of Ofwat's approach to assessing incumbents' costs associated with new developments at PR19, this was a contentious area of the price review with concerns by some stakeholders that the existing treatment of developer services may not always adequately permit incumbents to recover their efficient costs.

With improved data and time, there may be at least incremental improvements that can be made to the cost assessment at PR24 to address some or all of these concerns, particularly if there is increasingly evidence that the cost drivers for developer services vary considerably between companies.

- There may be ways in which Ofwat can improve outcomes from consumers in developer services via a new approach to price control regulation or incremental changes to the existing price control (e.g., new outcome delivery incentives linked to environmental outcomes).
- The design of the PR19 price control, via the DSRA, means that incumbents are revenue-neutral to the party that carries out contestable developer services work. A future system of regulation that provides profit-neutrality may instead be sufficient to support incumbents to play a market development role for contestable developer services and at the same time would help to reduce costs for end customers.

Alternatively, there may be benefits for consumers from incentivising incumbents to compete more actively for market share in new connections and development work – i.e., a situation where incumbents are neither revenue or profit neutral to market share – if in the longer term this is considered the best way to encourage cost efficiency and innovation in developer services within the water industry.

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<sup>58</sup> As discussed above, no regulatory system is perfect, and while the current regime may expose incumbents to certain cost recovery risks around their developer services activities, overall, the existing price control offers substantial cost recovery protection for the range of activities an incumbent wholesale water business is required to undertake.

Overall, these factors would suggest that there is opportunity at PR24 to improve the approach to economic regulation of developer services and to set the direction towards a better mix of markets and regulation in developer services in the future.

We have as a result, sought to develop a range of options for how developer services regulation could be adapted at PR24 and beyond, including incremental and more radical change options, given Ofwat's objective to look at options that might be applied at both PR24 and beyond.

In the next section, we briefly outline the assessment framework we have developed to assess the options which we set out and discuss in subsequent sections of the report.

## 4. OPTION ASSESSMENT FRAMEWORK

This section outlines our option assessment framework we have developed to assess the options we present in Section 5 below. The assessment framework is made up of four high-level objectives or criteria, which reflect the outcome of our analysis of key issues in Section 3:

- **Meeting customer needs and interests**

The approach to developer services regulation needs to ensure all customers’ needs are met given the current status of those markets.
- **Facilitate effective competition**

The approach to regulation should ideally promote a level playing field, so that efficient market entry is possible from SLPs and NAVs within markets for developer services.
- **Effective incumbent regulation**

Including factors such as ensuring that incumbents face an appropriate set of incentives and balance of risk and reward from the developer services activities and obligations they undertake.
- **Simplicity**

The approach to developer services regulation should avoid unnecessary complexity, and aim to be transparent, proportionate and targeted. The ease of implementation should also be considered.

The assessment framework is presented below, which has been developed in accordance with typical better regulation principles (e.g., transparent, accountable, proportionate, consistent and targeted).

Figure 4.1: Option assessment framework

Meeting customer needs and interests	Facilitate effective competition	Effective incumbent regulation	Simplicity
<ul style="list-style-type: none"> <li>• Customer protection</li> <li>• Quality of service</li> <li>• Fairness</li> </ul>	<ul style="list-style-type: none"> <li>• Level playing field</li> <li>• Predictability</li> </ul>	<ul style="list-style-type: none"> <li>• Efficient cost recovery</li> <li>• Appropriate incentives</li> <li>• Balance of risk &amp; reward</li> <li>• Flexibility</li> </ul>	<ul style="list-style-type: none"> <li>• Transparency</li> <li>• Proportionate</li> <li>• Targeted</li> <li>• Ease of implementation</li> </ul>

Source: CEPA

We consider our assessment framework to be aligned with Ofwat’s duties that are laid down in sections 2 and 3 of the Water Industry Act 1991 (WIA91).<sup>59</sup> In particular, sections 2 and 3 of WIA91 say that Ofwat must carry out its work in the way that will best:

- Further the consumer objective to protect the interests of consumers, where appropriate by promoting effective competition.
- Secure that the water companies properly carry out their statutory duties, and can finance their statutory duties.
- Secure the long-term resilience of water companies’ water supply and wastewater systems.
- Promote economy and efficiency by water companies in their work.
- Have regard to principles of best regulatory practice.

In the remainder of the section, we discuss each objective briefly.

<sup>59</sup> Available [here](#).

## **4.1. MEETING CUSTOMER NEEDS AND INTERESTS**

Meeting customer needs and interests are at the forefront of Ofwat's duties and therefore play an important role in our assessment framework. The regulation of developer services must meet the needs and interests of all developer services customers, which include developers / new customers, SLPs, NAVs and end customers.

The current regulatory framework provides considerable protection to all consumer groups via the network plus price control, incentive mechanisms and charging rules. The approach to regulation at PR24 will need to continue to offer consumer protection given that the state of competition in developer services markets varies considerably across incumbent areas.

The regulatory approach must also keep in mind the 'fairness' of developer services cost recovery between new and existing customers and the wider impacts that water and wastewater services can have on the environment.

Markets can lead to distributional outcomes that are not always considered to be "fair", which targeted regulation can in principle be used to help address. Ofwat has also emphasised the importance of the water industry managing its environmental impacts positively and effectively in its sector<sup>60</sup> and PR24 challenges papers<sup>61</sup>. Both of these factors are linked to the important public value role that Ofwat and other stakeholders have identified that incumbent water companies can play in supporting local communities and the environment.

## **4.2. FACILITATE EFFECTIVE COMPETITION**

Regulation of developer services should aim to facilitate a competitive market for contestable developer services activities (i.e., a level playing field that supports effective market outcomes) given that contestability is feasible, and, in the right circumstances, competition can lead to effective outcomes for customers.

At the same time, the approach to regulation needs to protect developers and other market participants from any abuse by incumbents of their monopoly/dominant position. As part of this, incumbents must be incentivised or obliged to provide a good quality of service to SLPs and NAVs (e.g., timely provision of information) or not to act on their dominant position within the marketplace.<sup>62</sup>

Based on stakeholder feedback, the regulatory framework might also aim to facilitate predictable, transparent and stable incumbent developer charges. This helps SLPs/NAVs to assess whether it is in their interest to enter the market and compete with the incumbent for developer services work, whilst also enabling developers to accurately price in the cost of developer services when purchasing land.

## **4.3. EFFECTIVE INCUMBENT REGULATION**

The developer services regulatory framework at PR24 should aim to:

- provide an adequate and efficient level of funding to the incumbents for the services they provide;
- provide clear and appropriate incentives;
- achieve an appropriate balance of risk and reward; and
- make best use of the information available.

Stakeholders highlighted that the current approach to regulating developer services is well meaning as it attempted to mitigate some of issues faced in PR14 (e.g., introduction of the DSRA to protect incumbents from volume risk).

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<sup>60</sup> Ofwat (October 2019): 'Time to act, together: Ofwat's strategy'

<sup>61</sup> Ofwat (December 2020): 'PR24 and beyond: Future challenges and opportunities for the water sector'.

<sup>62</sup> See discussion of incumbent incentives below.

By design it also largely protects incumbents from market share / competition risks in developer services. Alternative regulatory systems may not create the same incentives, which could lead to incumbents instead being far more sensitive to the supply route chosen by the developer, which may bring benefits and costs. Concerns were also raised by stakeholders on the approach taken to assess developer services costs at PR19, and whether additional data collected by the incumbents could be used moving forward to improve the developer services cost assessment approach (if required).

#### **4.4. SIMPLICITY**

The developer services regulatory framework at PR24 should aim to be proportionate and not unnecessarily complex. A number of stakeholders highlighted that the current approach to developer services regulation is complex and may not always create the right incentives in all circumstances:

- On the one hand, the approach to developer services regulation needs to address primary objectives we set out above – protecting customer needs and interests whilst promoting effective markets where appropriate – via creating appropriate incentives and constraints on incumbents’ behaviour and charges.<sup>63</sup>
- On the other hand, an overly complex system of regulation may mean it is challenging to identify if primary objectives are being met in practice, and whether the degree of regulatory intervention in the supply of developer services is proportionate to the market failures that may or may not exist.

The complexity of the of the developer services regulatory approach has as consequence been one of the key areas of focus in our option assessment.

But we would also be mindful of implementation challenges that arise as a result of regulation changes. The current treatment of developer services in the wholesale network plus price control, and its effects in terms of the risks and incentives that it creates for incumbent companies, is well understood, and as discussed in previous sections of the report, would be implementable approach at PR24.

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<sup>63</sup> Particularly the most vulnerable or those customers in market segments that may not benefit from competition.

## 5. DEFINING OPTIONS FOR PR24 AND BEYOND

We have developed options for PR24 using a two-stage option development framework:

- **Stage 1: option spectrum.** We define a series of options in terms of the treatment of contestable developer services within incumbents’ price controls. This results in a set of options that rely more or less on ‘ex-ante’ (i.e., price controls) versus ‘ex-post’ (i.e., monitoring and enforcement) options for the treatment of developer services in PR24 and beyond.
- **Stage 2: detailed design and implementation.** We define a series of practical issues and sub-options that need to be considered as part of each option identified in Step 1. These steps lead to a set of building blocks that make up a range of strategic alternative models for the treatment of developer services. A number of these building blocks are not mutually exclusive to one option on the spectrum.

### 5.1. STAGE 1: OPTION SPECTRUM

Ofwat’s overarching aim for this study is to assess whether customers would be better served by developer services remaining in the price control, or by reducing the regulation of developer services and relying on market outcomes. We consider this question is best explored through the options spectrum presented below.

Figure 5.1: Developer services option spectrum



On the left end of the spectrum, developer services would be regulated through ex-ante (binding) price control regulation, similar in approach to that adopted at PR19. On the right end of the spectrum, developer services are regulated through ex-post / enforcement regulation (i.e., The Competition Act 1998 and charging rules).<sup>64</sup>

We have identified three strategic points on this spectrum that represent reasonably well-defined points of comparison, which are described in the table below.

Table 5.1: Summary of options

Option	Description
Option 1: Proactive regulation	Option 1 is the closest option to the existing approach to regulating developer services and we have split it into two sub-options for consideration: <ul style="list-style-type: none"> <li>• 1a) Developer services regulated within wholesale network plus</li> <li>• 1b) Developer services regulated using a separate developer services price control</li> </ul>
Option 2: ‘backstop’ regulation	Option 2 would lead to a more fundamental change in the approach to regulating developer services as it would rely on ex-post ‘backstop’ regulation <sup>65</sup> for contestable developer services excluded from the wholesale network plus price control. This would be akin to Ofgem’s approach to regulating contestable new connections in the electricity sector where the regulatory treatment of different types of connections is dependent on indicators of the level of competition in each market segment.
Option 3: reliance on competition powers	Contestable developer service charges/prices would not be formally regulated and there would be a reliance on ex-post enforcement of competition law in regulating consumer outcomes. Non-contestable developer services – e.g., elements of reinforcement work – would be expected to be included in the incumbents’ network plus price controls.

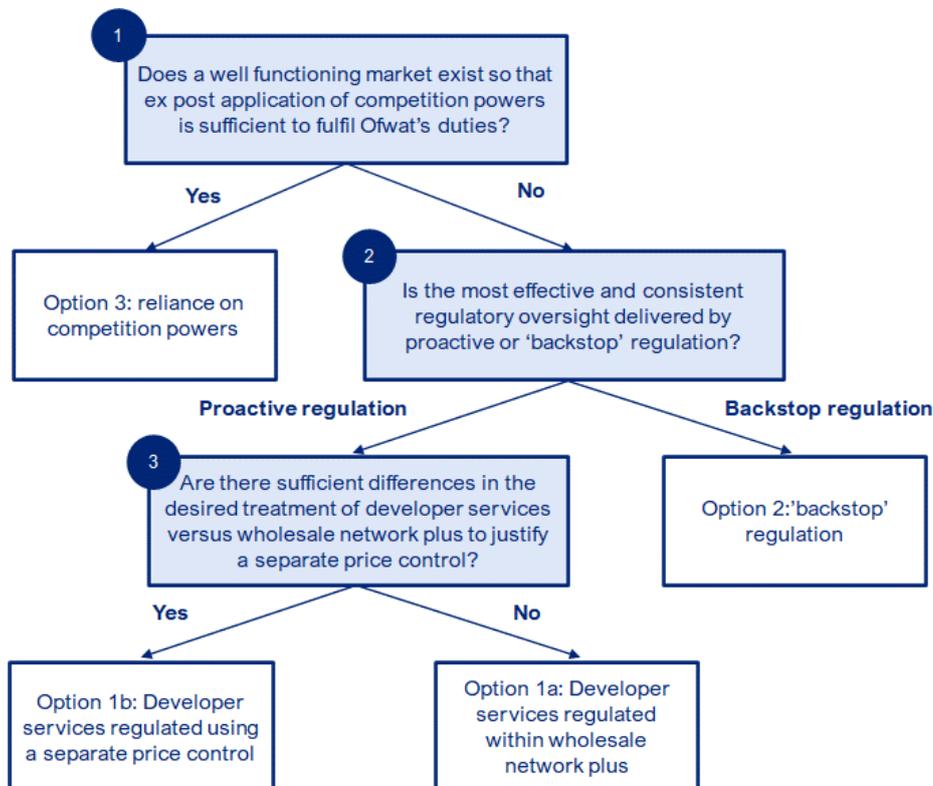
Source: CEPA

<sup>64</sup> The Competition Act 1998 prohibits any agreement, business practice or conduct which has, or could have, a damaging effect on competition in the United Kingdom. Available [here](#).

<sup>65</sup> Restrictions on the regulated margin that incumbents are permitted to earn on services that are excluded from the price control. The permitted margin may be zero in circumstances where there is limited evidence of contestability.

These are not the only options that could be considered but there was a general consensus among stakeholders that participated in the workshop for this project that these captured an appropriate spectrum of high-level options across a spectrum. To arrive at these options, we asked ourselves three important questions, that are presented as a decision tree in Figure 5.2.

Figure 5.2: Summary of options and key questions



Source: CEPA

We examine each of the three questions in more detail below.

### **(1) Does a well-functioning market exist so that ex-post application of competition powers is sufficient to fulfil Ofwat's duties?**

If the answer is 'yes', then it would be appropriate to land to the right of the options spectrum and rely on the application of competition powers in the developer services market (i.e., option 3). But if the answer is 'no' then some form of direct regulation of developer services is required, whether that is more proactive price control regulation (i.e., option 1) or the use of 'backstop' regulation (i.e., option 2).

In part, this assessment depends on the issues we have identified in Section 3, particularly those related to the status of developer services markets (Section 3.1) and the effectiveness and efficiency of the status quo approach which changes at PR24 would be expected to address (Section 3.2).

In general, we concluded in Section 3 that some balance of markets and regulation was likely to be needed in PR24. However, given that one of the objectives of the study is to consider options that might help inform the longer-term direction of the regulation of the sector, we have retained option 3 within our assessment, even if it may not be a fully viable approach for PR24.

### **(2) Is the most effective and consistent regulatory oversight delivered by proactive or 'backstop' regulation?**

The answer to this question depends on:

- **Expected role of the incumbent.** If the incumbent is expected to actively facilitate market development, in addition to competing for business, then proactive regulation is likely to be preferred. Whereas backstop regulation may be sufficient if the market is sufficiently well developed (or developing) and it is considered that it is beneficial for incumbents to more actively compete for market share.

- **Desired risk allocation and incentives.** Proactive regulation is likely to be preferred if there is a consumer-interest case for insulating incumbents from demand or cost risk, or more proactive regulation is considered able to put in place a desired set of incentives on incumbent companies, e.g., via benchmarking of costs or promoting environment outcomes.<sup>66</sup>

### **(3) Are there sufficient differences in the desired treatment of developer services versus wholesale network plus to justify a separate price control?**

If the answer to question 2 is that proactive regulation of developer services is required, it is then important to decide whether developer services should be treated separately from other wholesale water and wastewater network services to justify a separate developer services price control.

Implementing a distinct form of developer services regulation requires an active desire to change one or more of the key features of current wholesale water and wastewater network plus regulation, which include:

- insulation from market share risk through the revenue cap;
- RCV-based remuneration and profit;
- joint assessment of wholesale network plus costs; and
- the existing single till treatment of developer services revenue.

## **5.2. STAGE 2: DETAILED DESIGN AND IMPLEMENTATION**

In this section, we first explore each option in detail before considering a series of cross-cutting issues that need to be addressed for all options.

### **5.2.1. Option 1: Proactive developer services regulation**



As discussed above, Option 1 is split into two sub-options for consideration:

- 1a) Developer services regulated within wholesale network plus.
- 1b) Developer services regulated using a separate price control.

We discuss each of these in turn below.

#### **Option 1a: Developer services regulated within wholesale network plus**

Option 1a would aim to implement incremental improvements to the current approach to regulating developer services without major structural changes to the overall form of regulation. Developer services would remain in the wholesale network plus revenue control and be regulated as part of the ex-ante price review for network plus activities. The expected focus at the PR24 review would be on seeking:

- Improvements to the price review cost assessment – i.e., how to set as effective as possible a baseline for developer services costs as a component of allowed wholesale network plus totex.
- To encourage incumbents to continue proactively supporting the development of developer services markets – e.g., a review of the effectiveness of D-MeX or increasing the scope of contestable activities.

<sup>66</sup> For example, if elements of developer services are within (outside) of the scope of ex-ante price control regulation, this may create different profitability incentives for the incumbent that derive from the treatment of costs and revenues.

- To identify ways that the design of the regulatory framework might be improved, e.g., to protect incumbents against or expose them to certain risks, or by incentivising incumbents to focus more on environmental outcomes.

Ofwat, through the price review process, would proactively set incumbents' cost efficiency targets – via benchmarking of developer services costs at the time of the price review – and establish company performance targets through guaranteed standards and/or price control performance incentives.

Table 5.2 summarises the issues that would need to be considered to implement option 1a.

Table 5.2: option 1a implementation issues and considerations

Component	Description
Overall form of control	<ul style="list-style-type: none"> <li>• Developer services retained in wholesale network plus price controls, thus subject to the overall revenue cap.</li> <li>• Developer services regulated as part of ex-ante price review every 5 years to reset the network plus price control.</li> </ul>
Revenue recovery	<ul style="list-style-type: none"> <li>• Developer services still forms part of wholesale network plus totex allowance, with developer services income deducted to determine net totex that is used to calculate wholesale charges and for totex cost sharing.</li> </ul>
Efficient cost recovery	<ul style="list-style-type: none"> <li>• It would be open to Ofwat to re-examine incumbent risk exposure. Should the DSRA be amended to protect incumbents from work mix as well as volume risks? Should the DSRA be amended to expose incumbents to market share risk?</li> <li>• How the existing SoLR role should impact the degree to which incumbents are entitled to recover efficient developer services costs might be considered.</li> <li>• As at PR19, it is assumed that developer services costs would be excluded from totex cost sharing (and therefore incumbents would bear unit cost risk).<sup>67</sup> As discussed in Section 3, currently this relies on the assumption that developer services income is equal to costs, which may not always be the case.</li> <li>• Collection of better quality developer service cost data may enable developer services costs to be fully excluded from totex cost sharing if that is desired.</li> </ul>
Approach to cost assessment	<ul style="list-style-type: none"> <li>• Collection of better quality data on developer services costs and cost drivers may be used to facilitate separate benchmarking of developer services costs.</li> <li>• Collection of additional cost driver data may enable Ofwat to account for the mix of work undertaken in the cost assessment.<sup>68</sup></li> </ul>
Standards, outputs and incentives	<ul style="list-style-type: none"> <li>• The normal mix of outcome delivery incentives (ODIs) – such as D-MeX – and guaranteed standards would remain available to Ofwat under this option.</li> <li>• Ofwat could also consider introducing new ODIs, e.g., linked to the environmental actions that incumbents are taking in their developer services.</li> <li>• For example, incumbents could be encouraged to support Ofwat's objectives for new homes to be water efficient and new sites to have sustainable drainage. While this may require actions from developers, there may be measures that water companies can put in place to give the best chance of their adoption.<sup>69</sup></li> </ul>
Incumbent financial return/profit	<ul style="list-style-type: none"> <li>• Through the return on the wholesale network plus RCV.</li> <li>• Incumbents could potentially price an opportunity cost of capital when setting their developer charges if the definition of 'cost reflective' charges was clarified to include this, although overall they would still be constrained by the revenue cap.</li> </ul>

Source: CEPA

<sup>67</sup> Given that the net totex allowance for cost sharing is net of G&C income.

<sup>68</sup> More complex work can lead to higher efficient unit costs, all else being equal, amongst a number of other cost drivers for developer services. The expected mix of work can be impacted by external factors such as SLP penetration.

<sup>69</sup> Ofwat is consulting on introducing environmental incentives in developer services charges as part of its current consultation paper Ofwat (April 2021): 'A consultation on the scope and balance of developer charges and incentives'.

As Table 5.2 indicates, a core premise of Option 1a is that at PR24 Ofwat would seek to make incremental improvements to both the network plus price control cost assessment, the performance standards and incentive framework applied to incumbents, and the DSRA.

The following options might be considered by Ofwat for the PR24 cost assessment:

- Consider how collection of additional cost driver data may enable Ofwat to account for the mix of developer services work in its base cost assessment, e.g., via additional explanatory variables in cost models.
- Include developer services within the network plus base cost assessment and use additional/better quality data that is collected on developer services costs and cost drivers to allow incumbents to make well justified company specific adjustment claims outside of the base cost econometric modelling during the price review, e.g., related to incumbents' specific operating environment.<sup>70</sup>
- Benchmark developer services costs separately at PR24 to better control for different developer services cost drivers, in particular volumes / mix of work across different incumbent areas, in reaching an overall allowance for gross wholesale network plus totex.
- Split elements of forecast developer services costs between base cost and enhancement expenditure, where there are elements of the planned work (e.g., strategic reinforcement) that are likely to be more one-off or unique and are not considered to share the same characteristics as other base cost expenditure (e.g., routine and predictable expenditure).

These options are not mutually exclusive, and Ofwat would need to explore during the early stages of the PR24 review what additional data would be required and available on developer services costs and cost drivers, given that all the options rely on enhanced reporting and data collection.

Standards and performance sub-options that Ofwat might explore under Option 1a include:

- Incremental improvement to D-MeX based on learnings from PR19. For example, does the incentive strike an appropriate balance between incumbent engagement with developers, SLPs and NAVs?
- New forms of ODI, e.g., financial incentives linked to the improvements in environmental outcomes achieved from their developer services activities.
- Greater use of guaranteed standards – e.g., if the measures introduced as part of the Code for Adoption Agreements was deemed to be insufficient leading into PR24.

Again, these options are not mutually exclusive, and work on incremental changes to the developer services standards and performance incentive regime at PR24 might apply to other options along the overall options spectrum as well as Option 1a (see subsections below).

As discussed in Section 3, the DSRA at PR19 protects incumbents from volume risk but does not protect them from work mix risk. It also protects incumbents from market share risk as incumbents are revenue neutral to the party who delivers the developer services. DSRA sub-options that Ofwat could explore under Option 1a include:

- Reducing work mix risk faced by incumbents by capturing different types of developer services work within the DSRA (e.g., small, medium and large developments).
- Potentially introducing separate DSRA mechanisms for the mix of non-contestable and contestable developer services work.<sup>71</sup>

Implementation of Option 1a would not require any fundamental changes to incumbents' cost allocation processes and existing charging rules for developer services. As illustrated in Figure 5.3 below:

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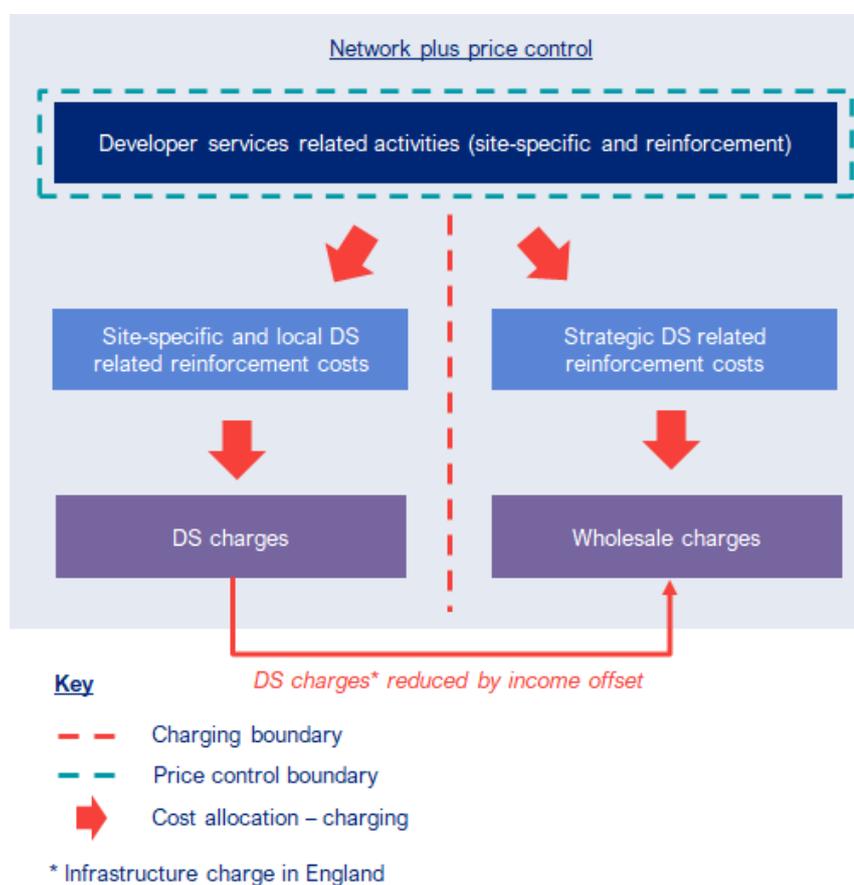
<sup>70</sup> e.g., level of SLP and NAV penetration and expected mix of developer services work, relative to industry averages.

<sup>71</sup> The latter could be designed in a way that exposes incumbents to an element of market share risk (i.e., no longer revenue neutral to the party who delivers the contestable developer services work).

- All developer services costs and activities would continue to remain within the scope of the wholesale network cost price control.
- Consistent with the existing 'semi-shallow' charging boundary:
  - Incumbents would need to allocate their costs to set cost reflective developer services charges, including charges for on-site work, requisition, and local reinforcement works.
  - Strategic reinforcement related to new developments would be recovered from wholesale charges as these costs are not included within the scope of G&C income.
- The income offset, where applied by companies, would provide a reduction to developer services charges and would require an increase in wholesale charges to compensate, as under the PR19 control.

We note that Ofwat is currently consulting on possible changes to new connection charging arrangements, including the treatment of the income offset. One of the possible outcomes of this consultation is the removal of the income offset from April 2025, which we have illustrated in Figure 5.3.

Figure 5.3: Possible charge setting processes and requirements under Option 1a with existing semi-shallow charging boundary and income offset rules



Source: CEPA

### Option 1b: Developer services regulated using a separate price control

Option 1b represents a larger departure from the status quo as developer services would be separated from the wholesale network plus controls. Developer services would remain regulated through a separate binding price control for developer services (i.e., separate from wholesale water and wastewater network plus).

As noted above, such a move would need to be justified based on a clear need to regulate developer services in a different way from its existing treatment under the umbrella of the network plus price control. If option 1b was adopted, a decision would need to be made on the form of the price control (i.e., revenue cap, price cap or average revenue cap), which would depend on what risks Ofwat considers incumbents should be exposed to.



recovering allowed revenues associated with the developer services price control. This approach may raise more cost allocation issues from the perspective of setting the separate developer services price control.<sup>72</sup>

Other changes that would need to be considered to successfully implement a separate developer services price control, are set out in the table below.

Table 5.3: Option 1b implementation issues and considerations

Component	Description
Overall form of control	<ul style="list-style-type: none"> <li>• Separate price control for developer services with separate revenue / price cap would need to be established.</li> <li>• A 'pay as you go' based price control rather than a traditional RCV-based control may be most appropriate given that developer services costs are variable with the number of connections and, therefore, behave like 'customer driven opex'.<sup>73</sup></li> <li>• Average revenue ('cost to serve') control or total revenue control (with or without a reconciliation mechanism) could be implemented depending on the desired treatment of volume and mix of work risk faced by incumbents.</li> </ul>
Revenue recovery	<ul style="list-style-type: none"> <li>• Developer services charges would recover costs in the developer services price control, while wholesale charges would recover the costs of network reinforcement that is not included in the developer services control. See discussion above.</li> </ul>
Efficient cost recovery	<ul style="list-style-type: none"> <li>• Depends on the form of control.</li> <li>• An average 'cost to serve' revenue control would protect incumbents from volume risk but may not protect them from market share and work mix risks. This could weaken their incentive to facilitate the development of the market.</li> <li>• In contrast, a revenue cap, with a cost sharing and DSRA mechanism, could be calibrated to allow companies to recover their efficient costs under a range of outturn volume, market and mix of work scenarios.<sup>74</sup></li> </ul>
Approach to cost assessment	<ul style="list-style-type: none"> <li>• As above for option 1a except the separate assessment of developer services costs is arguably more important in option 1b.</li> <li>• If it is not feasible to assess developer services costs separately, a second-best option could be to assess with other wholesale activities and disaggregate the developer services allowance afterwards (akin with water resources at PR19).<sup>75</sup></li> <li>• The average cost to service or any other benchmark used to set the price control may need to account for the varied levels of SLP/NAV penetration and variation in mix of work that each incumbent is expected to be required to undertake. See the options set out under option 1a for cost assessment at PR24 including options for changing the design of the DSRA applied at PR19.</li> </ul>
Standards, outputs and incentives	<ul style="list-style-type: none"> <li>• Same as option 1a.</li> </ul>
Financial return/profit	<ul style="list-style-type: none"> <li>• Depends on the form of the control.</li> <li>• If a 'pay as you go' based price control was implemented, incumbents could be allowed to earn a regulated margin based on working/risk capital requirements, potentially subtracted from wholesale WACC (as per residential retail) to ensure revenue neutrality.</li> </ul>

<sup>72</sup> For example, if incumbents were not able to accurately report separation of strategic/deeper reinforcement costs from local reinforcement costs at the time of the price review.

<sup>73</sup> We note that this does not mean that there is not considerable totex – i.e., opex and capital works – associated with the delivery of developer services. Rather that the costs associated with new connections activities may be better suited to a funding model that is 'pay as you go' instead of RCV ('slow money') based.

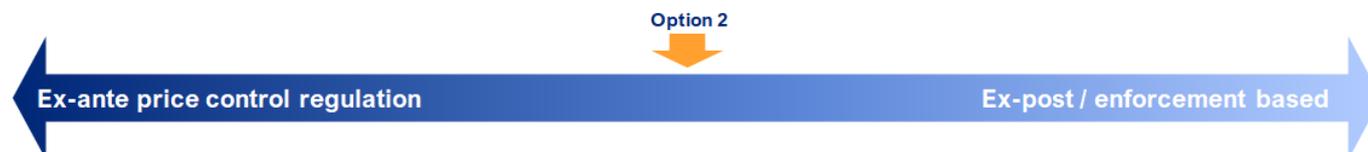
<sup>74</sup> Introduction of a developer services cost sharing mechanism may not be appropriate as SLPs/NAVs are not protected from unit cost risk. Incumbents have an SoLR role though, which SLPs/NAVs do not, which might be considered.

<sup>75</sup> Although this may weaken transparency and increase cost recovery risk.

Component	Description
	<ul style="list-style-type: none"> <li>If a more traditional RCV-based price control was implemented, incumbents could earn a return through the return on the developer services RCV. However, this may be difficult to achieve in practice given the charging implications.<sup>76</sup></li> </ul>

Source: CEPA

### 5.2.2. Option 2: ‘backstop’ developer services regulation



Under this option, contestable developer services would be excluded from the network plus price controls but would initially be subject to a capped regulated margin (either zero or positive). Non-contestable work would be expected to remain within the scope of the network plus price controls. This would be similar in objective to Ofgem’s approach to regulating new electricity connections (see Appendix A).

A decision would be needed as to which elements of developer services work were initially treated as ‘contestable’. A natural option would be to treat site-specific work as contestable and network reinforcement as non-contestable. This would be supported by anecdotal evidence from stakeholder engagement conducted as part of this study, which indicated that close to 100 percent of site-specific developer services work is contestable. When making the decision, Ofwat would need to be cognizant of the Code for Adoption Agreements, which encourages incumbents to increase the level of contestable activity over time.<sup>77</sup>

But Ofwat may judge it appropriate to treat certain activities that are contestable in principle as being non-contestable for the purpose of implementing Option 2. In order to simplify the drafting and narrative we have simply used the labels ‘contestable’ and ‘non-contestable’ without seeking to resolve, at this stage, the precise activities that fall into each category.

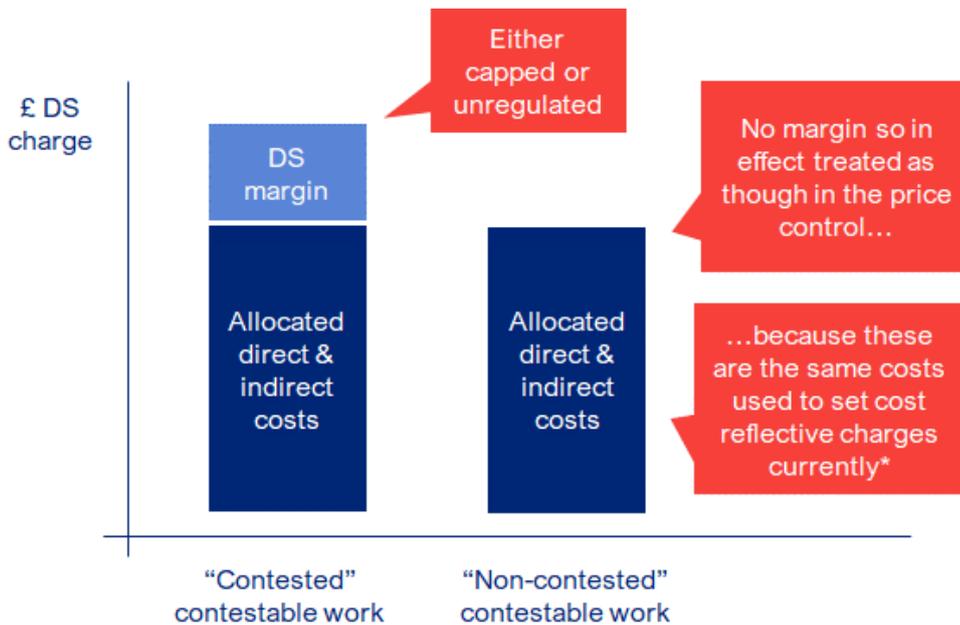
Option 2 is flexible and there is scope for the activities treated as ‘contestable’ to change over time. However, given that we assume the ‘non-contestable’ activities would be subject to cost assessment within the price control, it is likely to add significantly to the complexity of the regime if there is variation in the definition of ‘non-contestable’ activities during a price control or between companies.

The cap on contestable developer services charges (i.e., for contestable work excluded from the network plus price control) would prevent incumbents from charging a profit margin above their direct and indirect costs if Ofwat deemed there was not adequate competition to justify allowing any margin. From the *developer’s* perspective, this would in effect be the same as if the costs were included within the network plus price control, where incumbent companies set cost reflective developer services charges based on their expected direct and indirect costs incurred – see Figure 5.5 below.

<sup>76</sup> If developer services price control costs are capitalised in an RCV then they would need to be recovered from customers over time as the RCV is depreciated. This is not consistent with the current basis of developer services charges.

<sup>77</sup> Water UK, 2020. Water Sector Guidance in relation to the adoption of self-laid assets by Water Companies in England.

Figure 5.5: Treatment of contestable developer services under Option 2



Source: CEPA

\* This illustration assume that incumbents do not include any additional margin over and above the direct costs (including contingency) and indirect costs they expect to incur in providing the contestable works for new developments.

However, while incumbents' profit margins may be constrained (either from competition or via an imposed regulated cap by Ofwat) under this approach, incumbents may have an incentive to allocate developer service-related costs to the less contested market segments where incumbents face greater competition and scope to earn additional profit margins. As a result, Ofwat will need to ensure that there are clear cost allocation rules or principles in place that incumbents are bound to and which Ofwat could monitor and enforce over time.

The implementation of Option 2 would involve several discrete components:

- **Set-up:** assessing levels of competition to define which market segments should be subject to the regulated margin; or included / excluded from the network plus price controls.
- **Competition tests:** to enable incumbents to earn an unregulated margin.
- **Standards and monitoring:** to ensure companies are complying with regulation and providing good quality of service to customers.
- **Treatment of network reinforcement.**
- **Charging arrangements.**

We discuss each of these components in more detail below.

## Set-up

To implement Option 2, Ofwat would first need to determine on which contestable developer services activities, and in which market segments, incumbents should be permitted to earn a positive margin.

Incumbents would not be permitted to earn a positive margin on supposedly contestable activities where competition is unlikely to develop.<sup>78</sup> This is because they are effectively still a price-controlled activity where the opportunity cost of capital would be assumed to be provided via an allowed return on the expenditure associated with the new developments that is added to the RCV.

<sup>78</sup> For example, in regions which have very low levels of development activity and are unlikely to attract SLPs or NAVs, or for one-off connections involving single properties.

Determining whether a market segment should be allowed a regulated margin would need to involve engagement with incumbents, SLPs, NAVs and developers, as well as a holistic assessment in terms of the geographic distribution of development activity and the expected scope for competition. The types of competition tests described below might also be used to aid the initial assessment of competition.

When Ofgem implemented a similar system of regulation at DPCR5, the allowed margin was defined as net operating income plus fixed asset depreciation and amortisation, divided by net sales. The figure of 4% was determined based on the average margin (3.3%) across a sample of electrical contractors, taking account of the variation across the sample.<sup>79</sup> We note, however, that incumbents' developer services charges may already include a 'contractor' margin if they choose to deliver developer services work via a third-party contractor.

A key workstream under this option would be to establish an appropriate regulated margin benchmark.

## Competition tests

Following the implementation of a regulated margin, incumbents could be allowed to earn an unregulated margin if they pass certain competition tests. The aim of these tests would be to determine whether there are sufficient levels of competition in the relevant market segments to protect customers.

Table 5.4 provides an overview of potential tests, that draw on Ofgem's experience in the energy sector. It would be important to use data from several years to identify trends in the development of competition.

Table 5.4: Potential basis for competition tests

Topic	Details
Market share	<ul style="list-style-type: none"> <li>Incumbent company market share for different segments of the market (e.g., large developments vs., small developments).</li> </ul>
Market concentration	<ul style="list-style-type: none"> <li>Number of active SLPs and NAVs in an incumbent's area, and length of time active in the market.</li> <li>Market share of each developer services provider in an incumbent's area.</li> <li>Herfindahl-Hirschman Index (HII) based on the sum of squares of all the market shares in an incumbent company's area.<sup>80</sup></li> </ul>
Price	<ul style="list-style-type: none"> <li>Level of developer charges relative to other market segments or regions.</li> <li>Strong supporting evidence and transparency of cost reflective charging practices in setting of existing developer services charges.</li> </ul>
Customer awareness of competitive alternatives	<ul style="list-style-type: none"> <li>Evaluated via customer survey.</li> <li>Number of competitive quotations issued.</li> </ul>
Facilitation of competition	<ul style="list-style-type: none"> <li>Quality of engagement with SLPs/NAVs (e.g., ease of access to relevant network information).</li> <li>Quality of information provided (e.g., on incumbent website).</li> </ul>
Complaints	<ul style="list-style-type: none"> <li>Complaints by SLPs/NAVs to Ofwat / Consumer Council for Water (CC Water).</li> <li>Other evidence of non-compliance with spirit of competition.</li> </ul>
Compliance	<ul style="list-style-type: none"> <li>Breaches of regulation (e.g., cost-reflective charges).</li> <li>Clear documentation on charge setting processes and principles.</li> </ul>

Source: CEPA

Incumbents could be invited at PR24 to submit evidence of effective competition in their relevant markets, similar to Ofgem's approach in the electricity sector. Under this approach, Ofwat may wish to specify what type of evidence

<sup>79</sup> Ofgem, 2009. Electricity Distribution Price Control Review Initial Proposals – Incentives and Obligations. Ref: 93/09. Paragraph 10.38. Available [here](#).

<sup>80</sup> Ofgem in its assessment consider a maximum score of 1,000 is evidence of sufficiently rivalrous competition.

should be submitted, to minimise the administrative burden for all parties and better facilitate the assessment of competition.<sup>81</sup> The competition tests themselves could have three possible outcomes:

Figure 5.5: Outcome of competition tests<sup>82</sup>



Source: CEPA

Having put this system in place, Ofwat might expect periodically to review the state of competition of each market segment. As a result, the regulatory treatment of developer services would over time adapt to new information and changes in supply/demand conditions.

## Standards and monitoring

Option 2 is dependent on ex-post monitoring to ensure customers are protected, as opposed to ex-ante regulation.

Compliance with regulated margins could be monitored through periodic assessment of audited financial data submitted by incumbents. The incumbents would return any cost over-recovery to the customers directly affected where possible, should Ofwat determine that the regulated margin had been exceeded. Otherwise, the cost over-recovery would be returned to the end customer base via the wholesale network plus price controls.

In principle, D-MeX – or a reformed D-MeX – could remain in place to incentivise incumbents on the quality of service they provide to developers, SLPs etc. Alternatively, Ofwat could consider the introduction of a guaranteed standards of performance (GSOP) style scheme to further enforce certain minimum standards, noting that the recent Code for Adoption Agreements may already provide a similar incentive through the redress scheme.

Ofwat could also look to assess compliance with the standards via annual assessments ex post, similar to Ofgem's Incentives for Connections Engagement scheme<sup>83</sup>. In this case, if any company were to fail to meet the standards required, a penalty could be imposed. Company submissions could include:

- key performance indicators and other metrics (e.g., relating to the Code for Adoption Agreements);
- information on engagement delivered to developer services stakeholders within the previous year;
- a proposed strategy for engagement with stakeholders for the coming year; and
- evidence that any proposed strategy has been informed and endorsed by a broad and inclusive range of stakeholders.

## Treatment of network reinforcement work

We would envisage under this option that wider reinforcement – as a non-contestable activity – would remain part of incumbent companies' network plus price control. This would mean local and strategic network reinforcement costs would need to be included in the network plus price control cost assessment and totex baseline.

<sup>81</sup> We understand that at DPCR5, Ofgem did not specify what information was required to be submitted by DNOs.

<sup>82</sup> Under the alternative variant of Option 2 we have described above, market segments that fall within the 'little or no evidence of competition developing', i.e., the red category, would remain inside the network plus price controls.

<sup>83</sup> For further information, see Ofgem's Incentive on Connections Engagement Guidance document, available at <https://www.ofgem.gov.uk/ofgem-publications/87559/rrio-ed1guidanceicepdf>

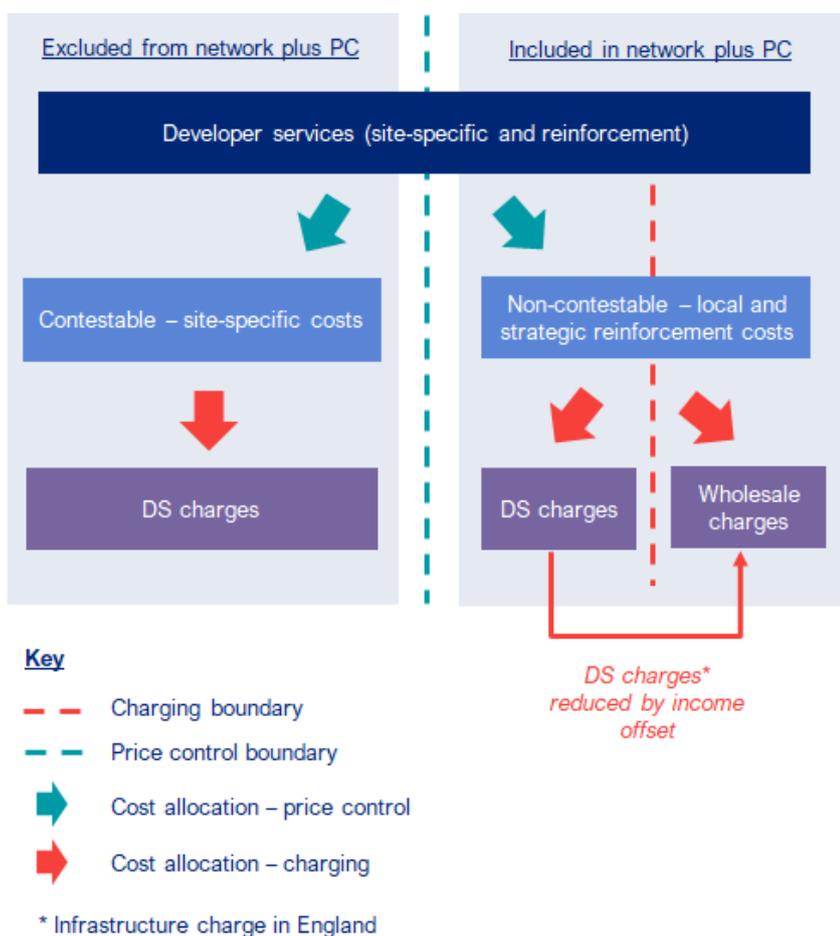
Consequently, the cost reporting framework at PR24 would need to be set up to enable clear separation of non-contestable and contestable activity costs and the process of cost assessment able to facilitate incumbents' recovery of efficient costs for network reinforcement work. As with other reform options discussed above, this would be reliant on good quality data and Ofwat's capacity to implement cost allocation policies that draw a 'line in the sand' between activities retained in the price control and activities that are excluded from the price control.

There is also a risk that by "thinning" the scope of developer services in an aggregated form of Base Cost assessment, the price control modelling may not adequately account for the variation in cost drivers for reinforcement works between incumbent areas. Ofwat might seek to mitigate this by including new cost drivers within its models and/or via special cost factor adjustments and separate technical assessments of spend.

### Charging arrangements

If Ofwat were to retain the existing 'semi-shallow' charging boundary under Option 2, then the cost allocation requirements would be similar to the 'narrower' scope for a separated developer services price control (option 1b). Developer services charges would in this case need to contribute to network plus allowed revenues and developer services excluded from the price control.

Figure 5.6: Charge setting and cost allocation processes and requirements under Option 2



Source: CEPA

### 5.2.3. Option 3: reliance on competition powers



Option 3 lies to the right of the options spectrum whereby contestable developer services prices would not be formally regulated by Ofwat. This would mean that contestable developer services would be fully removed from the network plus price control and developer services charges would not be subject to any ex-ante pricing restrictions.

However, as with Option 2, we would envisage that wider reinforcement activities and costs – as a non-contestable activity – would remain within the scope of the network plus price control.

For contestable developer services, there would therefore be full reliance on competition in the market and new connection charging rules to protect customer interests and ex-post enforcement of competition law, for which Ofwat has concurrent enforcement powers with the CMA (at least in relation to abuse of a dominant market position or anti-competitive agreements).

Option 3 involves the least regulatory intervention, which necessarily means there are fewer option specific issues to consider. However, Ofwat would need to be satisfied that it was resourced to monitor and enforce in an appropriate way to ensure that customers' needs and interests are being met by the market. Hence, this option may not necessarily be the least regulatory effort or burden. Additional 'self-regulation' measures could be introduced to ensure that certain minimum standards are maintained (e.g., enhancing the Code for Adoption Arrangements), which may reduce regulatory burden in the longer term.

There would naturally be a question under option 3 on whether there is a need for a 'SoLR' for services that may not be attractive to SLPs and NAVs (e.g., small developments or a single property connection to the existing network) given the essential nature of water and wastewater services – and if so, who fulfils that role and on what terms. For example, as discussed in Section 3, alternative SoLR arrangements could be considered.

#### **5.2.4. Cross cutting issues**

The discussion of the options we have set out above highlights a number of cross cutting issues across all options and may somewhat predetermine or constrain the feasibility and/or attractiveness of each option. For example, all the options rely on collection and analysis of better-quality information on market trends and/or incumbents' costs and revenues across different types of new development.

We have considered cross-cutting issues related to:

- Depth of charging boundary / sharing of costs between developers and wholesale customers.
- Cost allocation.
- Collection and use of developer services data.

#### **Depth of the charging boundary and the sharing of costs between developers and the end customer base**

In principle, there are three broad definitions of the 'charging boundary' for developer services, which reflects the costs developers could contribute to:

- **'Shallow' charging boundary:** where developers would contribute to site specific costs only (new connections, requisition and diversions).
- **'Semi shallow' charging boundary:** where developers would contribute to site specific and local reinforcement costs.
- **'Deep' charging boundary:** where developers would contribute to site specific and broader reinforcement costs (local and strategic reinforcement).

As discussed above, a form of semi-shallow charging boundary is currently used within the water industry. Costs on the new connection side of the charging boundary are also currently shared between new and existing customers via the income offset.

We have discussed above some of the issues that each of the options on our developer services regulation spectrum potentially raise if the existing charging boundary and income offset rules are retained in future. Some of the regulatory burden and complexity of the charging issues in each option might be reduced if Ofwat were to consider introducing a shallower charging boundary and/or removing the income offset.

As discussed above, Ofwat is currently consulting<sup>84</sup> on arrangements that would:

- Retain the existing ‘semi-shallow’ charging boundary (i.e., developers pay site specific plus local network reinforcement costs) but removes the income offset from PR24.
- Extend the existing practice of charges being differentiated depending on, for example, whether the site has sustainable drainage (‘environmental incentives’).

Assuming that this is the way forward for the sector in PR24, the following cross-cutting issues will need to be considered under options we set out above for regulation of developer services:

- For Options 1b and Option 2, what the implications and issues would be, if any, of developer services charges contributing to both wholesale network plus allowed revenue and either developer services allowed revenue (Option 1b) or excluded services from the price control (Option 2)?
- Under Option 2, what risks and unintended incentives could exist around the cost allocation and charge setting processes for incumbents if certain activities are excluded from the price control, while others continue to be included in the network plus price control?<sup>85</sup>

## Cost allocation

Options 1b, 2 and 3 all require a clear definition of developer services to ensure consistent cost allocation across incumbent businesses. The allocation of business overheads and indirect costs to developer services is particularly important and is unlikely to be a trivial exercise for incumbents to undertake, particularly for those who do not operate a separate developer services business unit within its overall wholesale business.

Similarly, the allocation of developer services costs (and revenue) between contestable and non-contestable activities is particularly important for option 2 and 3. Engagement with stakeholders through this study has indicated that an assumption that site specific work is contestable is reasonable, although there may be a small number of activities within this work that can only be conducted by the incumbent because of the risks involved (e.g., connection to the existing network, design of network diversion, connection of diverted network).

Ofwat’s current guidance on cost allocation is focused on seven core principles – transparency, causality, non-discrimination, no cross subsidy between price controls, objectivity, consistency and principal use.<sup>86</sup> More prescriptive guidance might be needed to implement options 1b, 2 or 3 to ensure consistent and accurate cost allocation between incumbents, akin to guidance on allocation of costs between retail and wholesale).

## Collection and use of developer services data

Data currently provided by the incumbents in relation to developer services can be divided into five areas:

- new connection charges information;
- revenue data;
- cost data;
- cost driver data; and
- market information.

Developer services data collection and use could be improved and underpins the proposals in a number of the reform options set out above. Improved data collection would also enable Ofwat to make a more informed decision on which option to adopt given the trade-offs with all options (see Section 6).

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<sup>84</sup> Ofwat (April 2021): ‘A consultation on the scope and balance of developer charges and incentives’.

<sup>85</sup> For example, if certain strategic reinforcement works are included in the network plus price control but are recovered directly from developers via infrastructure charges, would the treatment of the investment within the price control totex allowances create new incentives around cost allocation between price-controlled works and works excluded from the price control.

<sup>86</sup> Ofwat, 2021. RAG 2.08 – Guideline for classification of costs across the price controls. Available [here](#).

We propose that data additions and refinements are considered in collaboration with the incumbents and wider stakeholders to ensure that the data collected is relevant, accurate, consistent and transparent. We recognise that the industry already has considerable data reporting requirements placed on it. Therefore, any proposals for collection and use of developer services data will need to consider the cost benefit trade-off from greater collection and use of developer services data and clearly targeted to the future direction of regulation of these activities.

### **5.3. SUMMARY**

In this section we have set out a series of options for future developer services regulation in the water sector. These rely more or less on 'ex-ante' (i.e., price controls) versus 'ex-post' (i.e., monitoring and enforcement) approaches for the treatment of developer services in PR24 and beyond. We have set out a series of sub-options and key issues that would need to be addressed within each of these options.

In the next section of the report, we assess each of the options against our assessment framework and discuss possible ways forward given the range of objectives that Ofwat might wish to achieve at PR24 and looking beyond the forthcoming price review.

## 6. ASSESSMENT OF OPTIONS

In this section we firstly assess each option against the assessment framework set out in Section 4, then examine how Ofwat could decide between each option, before outlining a possible way forward for developer services regulation at PR24 and beyond. We have graded each option against the assessment framework using a Red Amber Green (RAG) scoring system:

- Red (R) – the option performs poorly against the objective / assessment framework.
- Amber (A) – the option performs satisfactorily against the objective / assessment framework.
- Green (G) – the option performs very well against the objective / assessment framework.

### 6.1. OPTIONS ASSESSMENT

#### 6.1.1. Option 1a: Developer services regulated with wholesale network plus

Option 1a would allow Ofwat to focus on creating an effective price control settlement for developer services at PR24 – with more time and information to introduce incremental improvements to the regime – without necessarily seeking fundamental changes to the overall approach to regulation.

Ofwat can as a consequence focus at PR24 on questions such:

- What is the most effective approach to assessing developer service costs – e.g., as a separate activity or as part of general network plus base costs?
- How should the cost modelling at PR24 account for differences in the potential cost drivers of developer services between incumbents' supply areas?
- What new ODIs related to developer services might be in customers interests given the strategic focus for PR24 – e.g., supporting environmental outcomes?

If the current treatment of the variation in volume of connections, via the DSRA, was largely retained at PR24, incumbents would continue to remain revenue neutral to their market share in contestable developer services, which alongside a performance incentive such as D-MeX, should mean they are incentivised to actively promote markets in developer services, rather than seeking to limit any loss of market share.

Possible disadvantages of Option 1a are that it maintains what some stakeholders have said is a relatively complex system of regulation and could mean developer services is as contentious an area of the price review as it was at PR19. Although to the extent that issues raised around the cost assessment at PR19 could be addressed, via new tools and potentially better data and information collection, this may not in practice be the case.

Table 6.1 sets out our assessment of Option 1a in more detail.

Table 6.1: Assessment of option 1a

Objective	Advantages	Disadvantages	RAG rating
Meeting customer needs and interests	<ul style="list-style-type: none"> <li>The regulatory framework would provide considerable protection to all consumer groups via the overall price control, incentives (e.g., D-MeX) and charging rules.</li> <li>New reporting information and collection on costs and revenues, may help monitoring of 'cost reflectiveness' of developer services activities, as well as the effectiveness of their treatment in the cost assessment.</li> <li>The price control might be used to proactively introduce new ODIs, e.g., linked to environmental outcomes associated with developer services during PR24.</li> </ul>	<ul style="list-style-type: none"> <li>Monitoring of cost reflectiveness depends on the quality and consistency of data provided by companies.</li> <li>May not create as strong an incentive for incumbents to seek cost efficiencies and service innovations than if they are exposed to competition risks and benefit from increasing / retaining market share in contestable developer services.</li> <li>As with the status quo, may create bill volatility from the interaction between developer services charges and the requirement for incumbents to comply with the network plus price controls revenue cap.</li> </ul>	
Facilitate effective competition	<ul style="list-style-type: none"> <li>Allows Ofwat to balance incentives for incumbents to <i>promote</i> rather than limit market penetration of SLPs and NAVs.</li> <li>Introduction of new regulatory measures, such as an alternative form of DSRA at PR24, may encourage incumbents to facilitate competition further.</li> </ul>	<ul style="list-style-type: none"> <li>The single till revenue cap does not allow incumbents to retain a financial reward from competing for developer services work and gaining market share.</li> </ul>	
Effective incumbent regulation	<ul style="list-style-type: none"> <li>Price control regulation within a single till may limit unintended incentives to allocate costs to activities where there are lower cost recovery / competition risks.</li> <li>Collecting better quality data on developer services costs and drivers, and investigating new cost assessment tools, may help facilitate a better estimate of efficient developer services costs at PR24 and increase transparency.</li> <li>Inclusion in the network plus price controls enables relative efficiency benchmarking by Ofwat of all (including contestable) developer services costs.</li> </ul>	<ul style="list-style-type: none"> <li>Risk as with the current regime, that incumbents are incentivised to run their developer services as more of a cost rather than 'profit' centre<sup>87</sup>, which may limit incentives to innovate compared to regulatory systems where incumbents can receive greater benefits from more actively competing for contestable developer services works.</li> <li>Granular reporting on costs, will impose a regulatory burden on companies in terms of reporting requirements.</li> </ul>	
Simplicity	<ul style="list-style-type: none"> <li>While complex, retains a reasonably well understood approach to developer services regulation and the steps to implement PR24 would be well understood.</li> </ul>	<ul style="list-style-type: none"> <li>Maintains a complex system of regulation.</li> <li>Several of the possible incremental changes discussed in Section 5 under this option would be likely to increase rather than reduce the degree of complexity.</li> <li>Retains a system of regulation that arguably is not particularly transparent given the relatively</li> </ul>	

<sup>87</sup> Unless a reformed DSRA no longer keeps incumbents' revenue neutral to the provider of a new connection.

complex interactions between developer services charges (G&C income) and the setting of wholesale charges within a single till price control.

Source: CEPA

### 6.1.2. Option 1b: Developer services regulated using a separate price control

Option 1b has similar advantages as 1a but could potentially provide greater flexibility for Ofwat to take a more targeted and focused approach to developer services price control regulation at PR24.

Option 1b retains the customer protections of a price control like the status quo, but by requiring the separation of developer services from the network plus price control, it creates a more focused system of regulation aligned to the needs to the specific activities in question. It also creates the conditions for Ofwat to exclude contestable developer services from the price control in future (should it deem this appropriate).

Option 1b would require greater transparency of developer services costs and cost allocation processes, in order to give effect to the separate price control to start with. This may allow Ofwat to focus on potential sources of cross subsidisation between different activities, which in turn may benefit competition through greater confidence that alternative providers are competing on equal terms.

How it would impact incumbents' incentives and behaviour would depend on the form of the price control Ofwat seeks to introduce and its treatment of costs and revenues.

- If the price control is a revenue cap, then similar to Option 1a, the incumbent might be expected to be protected from volume risks via a DSRA mechanism.
- If a price cap or set of price caps – i.e., an average cost to serve – then incumbents would be permitted to recover additional revenues if volumes increase provided that they comply with the price cap(s).

Option 1b is likely to require a far more fundamental regulatory design project at PR24, in contrast with Option 1a where Ofwat could focus on a narrower set of questions related to the treatment of costs and revenues at the price review. However, one of the potential attractions of Option 1b is that it would require many of the activities and reporting changes that would be necessary to implement Option 2. So, while Option 1b may require a more substantial regulatory design workstream at PR24 than Option 1a, looking beyond PR24, it could provide a steppingstone towards a lighter touch approach like Option 2 at future price controls.

Table 6.2: Assessment of option 1b

Objective	Advantages	Disadvantages	RAG rating
Meeting customer needs and interests	<ul style="list-style-type: none"> <li>• Same as option 1a.</li> </ul>	<ul style="list-style-type: none"> <li>• Same as option 1a.</li> </ul>	
Facilitate effective competition	<ul style="list-style-type: none"> <li>• Conceptually closer to how SLPs are operated and financed, which may better facilitate a level playing field.</li> <li>• Likely to contribute to the transparency of costs that are allocated from the wider business to developer services. This may allow Ofwat to focus on potential sources of cross subsidisation between different activities.</li> </ul>	<ul style="list-style-type: none"> <li>• Similar to option 1a. The incentive for incumbents to compete for market share may depend on the form of the separate developer price control(s) put in place.</li> </ul>	
Effective incumbent regulation	<ul style="list-style-type: none"> <li>• Would provide flexibility for Ofwat to take a targeted and focused approach to developer services</li> </ul>	<ul style="list-style-type: none"> <li>• Complex to create the price control (e.g., cost allocation; form of price control).</li> </ul>	

	<ul style="list-style-type: none"> <li>regulation at PR24 via the separate price control.</li> <li>For example, a targeted approach could be taken to the cost assessment, to capture the range of cost drivers that incumbents face in their respective supply areas.</li> <li>May offer a steppingstone into Option 2 or other lighter touch regulatory approaches at a future date, from the introduction of the separation of developer services from the wider network plus price control.</li> <li>Inclusion in price control enables relative efficiency benchmarking of all (including contestable) developer services costs.</li> </ul>	<ul style="list-style-type: none"> <li>The ‘deeper’ the charging boundary the more challenging it may be to implement the price control.<sup>88</sup></li> <li>A separate developer services cost assessment likely to be challenging based on PR19 experience. Unlike Option 1a, Option 1b is more reliant on the feasibility of setting an independent baseline cost assessment for developer services to justify the complexity of creating a separate price control.</li> <li>Could create unintended incentives around cost allocation, if the treatment of costs is different in the developer services price control than the network plus price control.<sup>89</sup></li> </ul>	
Simplicity	<ul style="list-style-type: none"> <li>May allow a targeted approach to developer services price control regulation.</li> </ul>	<ul style="list-style-type: none"> <li>A separate developer services price control would be challenging to design and implement.</li> <li>For example, under certain variants it could require substantial changes to charging and cost allocation rules as well as to cost reporting arrangements.</li> </ul>	

Source: CEPA

### 6.1.3. Option 2: Backstop regulation

Option 2, where certain contestable developer services are excluded from the price controls at PR24, should help to reduce the complexity of the regulatory approach once implemented whilst ensuring that customers remain protected (via backstop restrictions on developer services charges).

Backstop regulation may also help to facilitate competition in the market if it permits incumbents to include regulated margins for new entrants to compete against – ‘a price to beat’. For sectors of the market where a regulated margin can be charged, this may increase the incentive for further market penetration from SLPs and NAVs and may also increase the incentive on incumbents to compete for market share. It is possible though that in the short term this could lead to higher charges relative to the status quo.

Option 2 is likely to be challenging to implement in the first instance (e.g., requiring cost allocation principles, margin assessments and potentially licence changes) and would require ongoing monitoring moving forward (e.g., competition test review). This ongoing monitoring work once in place, may then help to reduce the resources that are needed to implement the sector’s more general price review cycles in future.

The backstop charging arrangements would need to act as a sufficient restraint on incumbents’ charging decisions and costs, alongside the competition enforcement powers that exist under all options, given that activities excluded from the price control would not be subject to relative efficiency analysis. Ofwat would therefore need to take a careful look at the state of competition in individual market segments and incumbent operating areas, and to design an effective set of backstop price restriction mechanisms to replace the network plus price controls.

Option 2 would also alter the balance of incentives for incumbents in terms of developers’ choice of supply route:

- Incumbents may more actively seek to compete for market share (in conflict with the current regime) if developer services are an additional source of income and returns.

<sup>88</sup> See discussion in Section 5.

<sup>89</sup> For example, if one price control is a revenue cap, while another is a price cap (average cost to serve).

- This incentive may strengthen if companies are exposed to cost recovery risks from variable volumes of work for a given set of annual charges.

For the reasons set out below, excluding certain activities from the network plus price control while leaving others within the scope of the revenue cap, may create incentives for incumbents to allocate costs to maximize market share and/or cost recovery from particular types of new development.

The table below sets out our assessment of Option 2 in more detail.

Table 6.3: Assessment of option 2

Objective	Advantages	Disadvantages	RAG rating
Meeting customer needs and interests	<ul style="list-style-type: none"> <li>• Customers are protected through the application of ex-post 'backstop' regulation on contestable developer services and the incumbents' obligation to set cost reflective charges plus the allowed margin for the market segment.</li> <li>• May incentivise efficiency improvements and better quality of service from incumbents to developers in competing for market share in the most contestable segments of the market.</li> <li>• Should support monitoring of 'cost reflectiveness' of incumbents charges for developer services as a result of the cost allocation rules and reporting needed to give effect to the regulatory regime.<sup>90</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Costs to consumers may increase for some customers if incumbents can add an additional margin to charges which are not applied under the current system of regulation.</li> </ul>	
Facilitate effective competition	<ul style="list-style-type: none"> <li>• Enabling incumbents to earn a direct margin on contestable developer services activities excluded from the price control should offer SLPs and NAVs a greater incentive to compete with incumbents.</li> <li>• The competition tests that trigger increasing deregulation of developer services charges (in terms of caps on margins) may also encourage incumbents to facilitate competition.<sup>91</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Incumbents would be more exposed to risks associated with their market share in developer services.</li> <li>• This could alter the balance of corporate incentives on the incumbents and introduce a degree of tension between their market development role and their role as competitors to SLPs.</li> </ul>	
Effective incumbent regulation	<ul style="list-style-type: none"> <li>• Simplifications in the regulatory framework, once in place, may offer clearer incentives for incumbents.</li> <li>• The issues incumbents have highlighted around the mix of work and cost recovery for site-specific work are addressed because incumbents are not constrained in</li> </ul>	<ul style="list-style-type: none"> <li>• Excluding activities from the network plus price control may limit the protection incumbents can be provided for certain risks.</li> <li>• Activities excluded from the network plus price controls would not be subject to a relative efficiency assessment by Ofwat.</li> <li>• Excluding certain activities from the network plus price control may incentivise incumbents to allocate developer service-related costs to</li> </ul>	

<sup>90</sup> Transparency of costs is necessary to give effect to the backstop charge restriction mechanisms on developer services activities excluded from the price control.

<sup>91</sup> Although Ofwat will need to be mindful that data on contested market segments is only transient, and incumbents are then able to significantly increase market share once individual market segments are increasingly price deregulated.

their charges by their overall revenue cap.<sup>92</sup>

activities that remain within the scope of the price control or to market segments where they face less competition, where this makes them more competitive in segments where there is greatest scope to earn additional profit margins.

Simplicity	<ul style="list-style-type: none"> <li>• Simplifies regulatory framework once in place – but would require preparatory work.</li> <li>• Removes need for challenging developer services cost assessment for site-specific work.</li> </ul>	<ul style="list-style-type: none"> <li>• Challenging upfront implementation process (i.e., cost allocation and licence changes), and will require ongoing monitoring and assessment over time.</li> <li>• Ofwat would still need to assess reinforcement costs within the scope of the price control, which may be challenging.</li> </ul>
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Source: CEPA

### 6.1.4. Option 3: Reliance on competition powers

To assess this option, it is helpful to consider Ofwat’s duties as a regulator. One of Ofwat’s duties requires it to "protect the interests of consumers, *wherever appropriate* by promoting effective competition". This suggests that Ofwat should favour a progressively greater reliance on competition in developer services over the long-term, provided that customers interests are sufficiently protected.

The evidence is consistent with there being further scope to introduce competition in the developer services market. There is little evidence that the limits of how effective competition can advance consumers’ interests have been reached. Much of what is covered by developer services is currently defined and treated as contestable. There are regions in England where SLP or NAV penetration is high, which indicates that competition is feasible even if not yet widespread. However, there is little evidence to demonstrate that full reliance on competition powers under Option 3 would be feasible or credible at PR24:

- Areas of low penetration are not necessarily problematic in and of themselves – but give rise to a concern about the ability of market participants to exert effective competitive pressure on unregulated incumbents.
- Even in areas where SLP or NAV penetration is high, it is not possible to infer that full competition has developed, as incumbents are not incentivised to compete for market share. Anecdotal evidence also suggests that SLPs and NAVs within a given supply region tend to also be focused on certain types of development, and so certain market segments can be considerably less contestable.
- Ofgem’s more competition-oriented approach does not extend to full reliance on competition powers.

It is possible that Option 3 may be appropriate in the context of water developer services in the future, provided that Ofwat has sufficient confidence that the market is sufficiently protecting the interests of developers and new connecting customers. But this is unlikely to happen in time for PR24.

The table below sets out our assessment of Option 3 in more detail.

Table 6.4: Assessment of option 3

Objective	Advantages	Disadvantages	RAG rating
Meeting customer needs and interests	<ul style="list-style-type: none"> <li>• Profit incentive should facilitate service innovations and desire for efficiency savings from incumbents to developers.</li> </ul>	<ul style="list-style-type: none"> <li>• Limited customer protections in place, which is unlikely to be appropriate given the considerable regional variation in SLP/NAV activity and evidence to suggest competition</li> </ul>	

<sup>92</sup> If the mix of contestable work is more costly or variable, this is potentially less of an issue for incumbents because the activities would be excluded from the price control and so incumbents would have greater pricing freedom going forward to charge for their incurred costs.

		is greater in some developer services market segments than overs.	
Facilitate effective competition	<ul style="list-style-type: none"> <li>Enabling the incumbents to earn an unregulated margin on contestable developer services activities should better facilitate a level playing field with SLPs and NAVs.</li> </ul>	<ul style="list-style-type: none"> <li>Leaves incumbents exposed to greater risk (e.g., market share risk), which may incentivise them to compete more actively for market share, rather than promoting alternative supply routes.</li> </ul>	
Effective incumbent regulation	<ul style="list-style-type: none"> <li>Limited regulatory intervention which should offer clearer incentives.</li> </ul>	<ul style="list-style-type: none"> <li>May not sufficiently incentivise cost efficiency given the regional variation in the level of competition.</li> <li>No flexibility to mitigate risk faced by incumbents.</li> </ul>	
Simplicity	<ul style="list-style-type: none"> <li>Low regulatory burden.</li> </ul>	<ul style="list-style-type: none"> <li>Ofwat would still need to monitor the market in an appropriate way to ensure that customers' needs and interests are being met.</li> <li>Hence, this option may not necessarily be the least regulatory effort or burden.</li> <li>Ofwat would still need to assess reinforcement costs within the scope of the network plus price control, which may raise challenges, as would be the case with Option 2.</li> </ul>	

Source: CEPA

## 6.2. BALANCING THE TRADE-OFFS BETWEEN OPTIONS

We summarise the outcome of our options assessment in the table below.

Table 6.5: Assessment summary – RAG ratings

Objective	Option 1a	Option 1b	Option 2	Option 3
Meeting customer needs and interests				
Facilitate effective competition				
Effective incumbent regulation				
Simplicity				

Source: CEPA

In summary:

- We do not consider Option 3 is a feasible option at this point in time** given the wide regional and market segment variation in SLP/NAV activity. Although there is evidence of high SLP/NAV penetration in some areas, we would not be confident that competition alone could sufficiently protect the interests and needs of all developers and new connecting customers. If the increasing deregulation of developer services charges is desired, we consider a more incremental approach is needed linked to evidence of competition in defined product/geographical markets in developer services (i.e. more akin to Option 2) given that incumbents do not currently face a financial incentive to win market share.
- The merits of options 1a, 1b and 2 are more finely balanced**, albeit that the additional work required to set up a new, separate price control likely makes option 1b the most complex of the three. The relevant question then for PR24 is which of the following options best addresses the main perceived issues with the current regulation of developer services, whilst putting developer services on the potential transition towards greater reliance on competition and ensuring that customer needs and interests are met?

- Option 1a - an evolution of the current approach, potentially with a view to a further transition towards option 1b or option 2 at PR29.
- Option 1b - separating developer services from the main price control, potentially with a view to a further transition towards option 2 during PR24 or at PR29.
- Option 2 - backstopped competition for contestable developer services at PR24, with non-contestable services retained in the network plus price control.

This naturally leads to the question of how Ofwat should decide between options 1a, 1b and 2? Considering the conclusions from our options assessment presented above, we discuss three key determinants for this decision in the subsections below.

## Meeting customer needs and interests and the role of competition

Ultimately customers' interests are promoted by provision of high-quality developer services and associated charges that reflect efficient costs from companies. These were the high-level objectives Ofwat set out to achieve under the existing regulatory framework. In principle at least, all our options (1a, 1b and 2) can facilitate these fundamental objectives, but they may over time achieve them to different degrees.

Option 1a and 1b would allow Ofwat to:

- Continue to benchmark and assess what are efficient incumbent costs over price review cycles, because all developer services activities would continue to be price controlled.
- Incentivise service quality improvement, like under the current system, where service quality is incentivised via a D-MeX mechanism. Like for cost efficiency, these targets could be progressively tightened over price review cycles, as industry performance improves.
- Consider new ODIs, e.g., linked to new environmental objectives for developer services, which incumbent companies can help to promote.

Option 2 in contrast would not provide the opportunity for regulatory cost assessment and efficiency analysis given that contestable activities would be excluded from the price control:

- Incumbents would be expected to set cost reflective charges for new connections and developments and so, like any competitive developer services business, charges that reflect their direct and indirect costs.
- Cost efficiency would be incentivised via competition in contestable developer services, on the assumption that SLPs and NAVs will apply sufficient discipline to incumbents' developer services costs.

The benefits in theory of Option 2 are then that the increasing deregulation of charges for developer services will help open up the sector to further competition, and over time, that this will allow the market to drive future improvements in cost efficiency and service quality that:

- are achieved without the need for costly regulatory oversight and intervention; and
- go beyond what is achievable via price control regulation in practice<sup>93</sup>.

Option 2 offers the prospect for further competition within developer services from two perspectives:

- It could give SLPs and NAVs more room to compete, if, as a result of price control deregulation, it forces incumbents to price in a margin in order to turn a developer services profit.<sup>94</sup>
- It also incentivises *incumbents* to compete for market share. This increases the scope for customer benefits if incumbents compete more actively for market share by seeking:
  - efficiencies in their businesses; and/or

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<sup>93</sup> Given for example, the known practical issues and limitations in developer services cost assessment (see above).

<sup>94</sup> Recognising that SLPs and NAVs are already free to compete for market share in any way they see fit, subject to any minimum standards that need to be met in providing services.

- service improvements and innovations where the balance of risk and reward from company investment in improving developer service offerings becomes more favourable as a result of activities being excluded from the network plus price control.<sup>95</sup>

In contrast, under option 1a in particular, the incumbents would continue to only earn profit through the return on the wholesale network plus RCV or through outperformance of the price control. Under a single till revenue cap, incumbents would not gain financially from winning market share. They would continue to have limited incentives to compete for business and improve their service offer, except for the disciplines created and applied via the price control and any performance incentives (e.g., D-MeX or ODIs) imposed by Ofwat.

Option 1b via the implementation of a separate developer services price control, might be able to address some of these issues, and could have benefits in terms of:

- focus of management attention on the particular activity of developer services; and
- allowing Ofwat, via the separation of price control activities, to focus on potential sources of cross subsidisation between different activities.

However, this option may still not promote as active competition from incumbents as Option 2.

This fundamental choice comes down to which of price control regulation or further competition in developer services Ofwat considers is more likely to impose greater discipline and incentive on incumbents, SLPs and NAVs to be efficient and seek out new service quality improvements for customers in the longer term.

## **Complexity / simplicity of the regulatory framework**

Complexity of the existing regulatory framework was raised as a material issue by stakeholders, and Ofwat is currently assessing how it can simplify the PR24 price review while increasing value to customers, the environment and wider society.<sup>96</sup> Two considerations are relevant to the choice between options:

- Would Ofwat be prepared to retain or even add to existing complexity by adopting an evolutionary approach (i.e., option 1a or 1b)? Option 1b could add to the overall complexity of the price control process by introducing a further disaggregated component.
- Option 2 should ultimately in the longer-term reduce complexity in the regulation of developer services by enabling a lighter touch approach once a new system is implemented. However, in the short-term the burden may be greater given the expected complexity in the implementation.

A long-term objective to ultimately have a lighter touch form of regulation for developer services might then favour a transition in PR24 towards Option 2. We highlight one exception to this conclusion:

- Some but not all of the complexity of the current form of regulation is a result of developer services being within the wholesale price control. The existing charging rules and charging boundary also makes the system complex.
- If Ofwat were to introduce a simpler set of charging rules and connection/charging boundary – e.g., via changes to income offset and/or the site specific and local reinforcement costs that developers are required to contribute to – then part of the complexity with Option 1a and 1b may be reduced.<sup>97</sup>

Nevertheless, we would expect Ofwat to want to address complexity in PR24. We consider that in the longer term this might favour Option 2, but in the short-term we would expect this option to involve extra work.

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<sup>95</sup> For example, if site-specific works are excluded from the network plus price controls, incumbents may have more of a commercial (as opposed to regulatory) incentive to develop new service offerings and products around water efficiency schemes, or more environmentally friendly infrastructure solutions for new developments.

<sup>96</sup> Ofwat, 2020. PR24 and beyond: Future challenges and opportunities for the water sector. Available [here](#).

<sup>97</sup> As discussed in Section 5, we understand that Ofwat are currently consulting on a number of possible changes to the new connection charges, including the application of the income offset at PR24.

## Effective incumbent regulation

In determining a way forward for PR24, Ofwat will also need to be satisfied that the option chosen allows incumbents to recover efficient costs associated with the delivery of developer services.

Each of our options will facilitate a different treatment of costs and the risks set out in Section 3, which in turn will impact to whom the risk is allocated and to what degree. We highlight the following key issues:

- Incumbents can potentially be protected from certain risks within a price-controlled regulatory framework (i.e., option 1a and 1b). But if elements of developer services are not a price-controlled activity (i.e., option 2), then this may expose incumbents to greater cost recovery risk.
  - On one hand, Option 2 cannot guarantee the recovery of the minimum efficient costs, primarily overheads, necessary to underwrite a SoLR role, given that incumbents' recovered revenues are linked to the volume of work delivered.<sup>98 99</sup> In other words, Option 2 cannot fully protect incumbents from market share risk.
  - But Option 2 can accommodate circumstances of high direct unit costs of work that SLPs and NAVs are not willing to actively compete for so long as Ofwat's regulations permit incumbents to charge the actual costs of connection and development.<sup>100</sup>
- Ofwat would need to be comfortable with moving away from the current regulatory approach whereby incumbents are not incentivised to compete for market share (i.e., being revenue neutral to the party who delivers developer services) in order to support option 2.
- Adjusting incumbents' exposure to mix effects risk is likely to be challenging under all options. Ofwat intended to partially protect incumbents from mix effects risk at PR19 through the DSRA mechanism but was unable to obtain consistent data at the level of granularity requested. But companies may have greater flexibility to mitigate their exposure to mix effects risk under option 2 absent a price/revenue cap.

A future system of economic regulation that continues to include developer services within the scope of an Ofwat price control (i.e., Option 1a and 1b) might naturally be considered to help support the recovery of efficient developer services costs. But we note that:

- This presumption is dependent on the range of cost drivers for developer services between incumbent areas being adequately captured within the price control cost assessment. This is dependent on better quality data and new cost modelling tools being developed at PR24.

Further evaluation would be needed to establish how material cost recovery risks would be in practice for incumbents under Option 2, in the context of the actual overheads they incur, and the additional commercial flexibility Option 2 might permit them in setting charges in future.
- There may be further supporting regulatory mechanisms that Ofwat could look to investigate, either as an interim or enduring measure, which might permit incumbents to claim additional allowed revenues under their wholesale price control to support justified variations in efficient costs between regional supply areas, e.g., as a result of very different levels of SLP and NAV penetration.

As a final consideration, we have noted above that Ofwat would need to be cognisant that with Option 2, the exclusion of certain activities from the network plus price control may create incentives for incumbents to alter their cost allocation practices, either to:

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<sup>98</sup> Although incumbent companies may be able to manage these risks if there is flexibility ex ante or ex post to price these risks in setting their developer services charges.

<sup>99</sup> Ofgem reduced this risk at DPCR5 by allowing the electricity Distribution Network Operators (DNOs) to provide evidence at the end of the period to demonstrate that an increase in competition in new connections, led to expenditure on the connections that remain in the price control being significantly above the ex-ante allowance. This evidence would then, subject to assessment, be reflected in the end of period volume driver true-up.

<sup>100</sup> As would be the case in Option 2 as incumbents would be capped on the level of profit *margin*, if any, they are permitted to earn from a given developer services segment.

- lower prices in the developer services market segments where they face the most active competition from SLPs and NAVs; or
- to allocate costs to activities where the cost recovery opportunities are greatest, depending on what is most financially beneficial across the scope of its regulated activities.

As a result, Ofwat will need to ensure that there are clear cost allocation rules or principles in place that incumbents are bound to and which Ofwat could monitor and enforce over time.

### 6.3. THE WAY FORWARD AT PR24 AND BEYOND

The choice around what path to go down (option 1a, 1b or option 2) will depend on the issues Ofwat wants to prioritise in PR24 (and beyond) with regards to developer services regulation and which approach, on the balance of probabilities, is most likely to meet the long-term needs and interests of customers.

Based on our options assessment, we consider the key questions for Ofwat are as follows:

- A. Are there quality/cost gains in developer services that might be achieved through greater competition that cannot be delivered via regulatory tools (D-Mex and cost benchmarking)?
- B. Is a lighter touch future form of developer services regulation favoured (i.e., one that may, in the longer-term, substantially reduce the degree of regulatory complexity and the cost of developer services regulation)?
- C. Can a system of developer services regulation adequately discharge obligations to incumbents given their SoLR role and the cost impacts of this obligation?

If Ofwat were to give priority to a system of regulation that facilitates efficient incumbent cost recovery (e.g., via a price/revenue control) and a process that allows it to benchmark efficient developer services costs in the interests of customers (e.g., via a price review) and to take a more proactive approach to supporting developer services markets and new objectives,<sup>101</sup> **then this would favour Option 1 (1a or 1b).**

**However, if, on the balance of principle and probabilities, the regulatory judgement is that the long-term answers to questions A and B are yes, then this would favour Option 2.** In this scenario, Ofwat would need several practical factors/conditions to hold to be confident in pursuing this direction at PR24:

- There is a reasonable prospect that enough developer services market segments in different company regions will have sufficient/adequate competition, that competition between incumbents and SLPs (as well as among SLPs) has the scope to deliver further improvements to the quality or cost of service over and above those that can be incentivised under price control regulation.
- The implementation process of moving to option 2 will not create a disincentive for incumbents facilitating new connections.<sup>102</sup>
- SLPs and NAVs are able to impose sufficient cost discipline on incumbents.
- Ofwat is comfortable changing the incentive on incumbents to want to compete more actively for developer services work, i.e., retain or gain market share, rather than being revenue neutral.
- The opportunity cost of considerable developer services reform is justified given other competing industry priorities in PR24, and implementation challenges can be adequately overcome in the available timescales.
- Removing the security of price-controlled revenue does not fundamentally undermine the SoLR role given it is a legal obligation.

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<sup>101</sup> For example, promotion of environmental benefits in developer services via direct regulatory incentives.

<sup>102</sup> For example, if undertaking new developments during the transition process of removing developers' services from the price control, creates high-cost recovery risks.

To decide on whether these factors/conditions do in fact hold, Ofwat will need to conduct further work and analysis to make an informed decision ahead of PR24. This will include:

- Separate reporting on developer services costs and revenue by different market segments.
- Reporting and analysis on the size of developments and their characteristics (e.g., level of contestability). This will enable Ofwat to define the relevant developer services product and geographic markets, and to split them into different market segments, and to form conclusions of what developments are not just contestable in principle, but also contested in practice.
- A solution to SoLR obligations and cost recovery.

As a final step, Ofwat would then need to decide how each market segment gets treated (i.e., remains in network plus price control; no margin; regulated margin; or no backstop price restriction), which will be informed by the analysis detailed above.

If Ofwat considers the conditions listed above hold after conducting the required analysis, then it might be confident in pursuing Option 2 in PR24. Otherwise, a variant of Option 1 would need to be pursued at PR24.

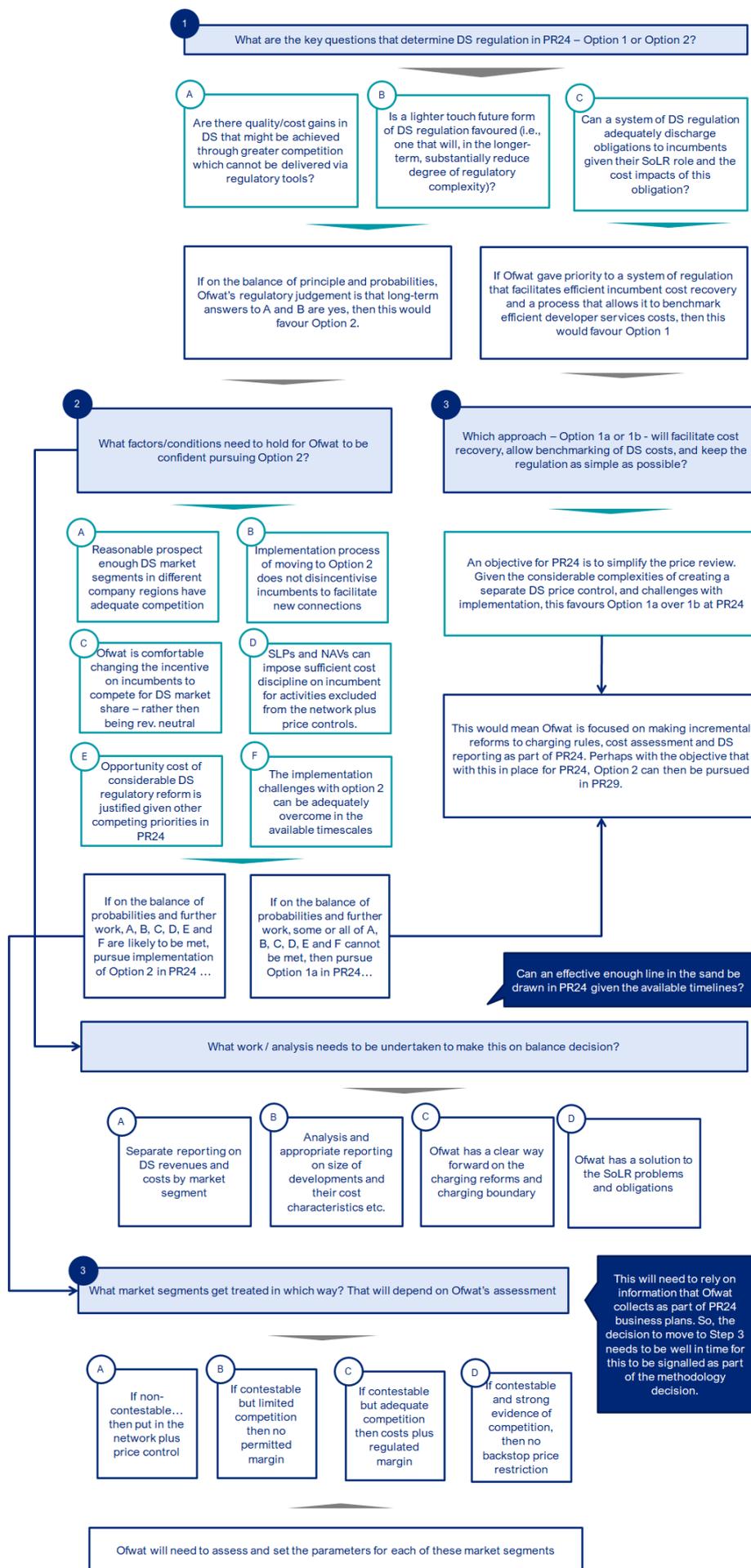
In the event that Ofwat decides to proceed with price control regulation, should Ofwat favour Option 1a or 1b?

As discussed above, one of Ofwat's objectives for PR24 is to simplify the price review while increasing value to customers, the environment and wider society. We therefore consider Option 1a is likely to be preferred over 1b at PR24 given the considerable complexities of creating a separate price control, the challenges with its implementation, and because many of the issues identified with the current approach to regulating developer services can be resolved under option 1a. Under this pathway Ofwat would, as a consequence, focus on making incremental reforms to developer services charging rules, data reporting (costs and cost drivers) and cost assessment as part of PR24. Ofwat could then reconsider option 2 at PR29 considering the development of the market over the PR24 period and the opportunities for further market maturity.

However, Ofwat may wish to consult with stakeholders on this conclusion before reaching a definitive position on option 1b. In particular, whether stakeholders consider a separate developer services price control would be an effective steppingstone to a more fundamental change in regulatory approach at PR29 given the transparency of cost allocation that the separate price control would bring.

The decision tree below sets out the process described above, which we believe should enable Ofwat to make an informed decision on the way forward for developer services (DS) regulation at PR24 (and beyond) based on the information available.

Figure 6.1: Potential developer services regulation decision tree



## 7. CONCLUSIONS

Ofwat's overarching aim for this study was to assess whether customers could be better served by developer services remaining in the wholesale price controls at PR24, or by reducing the regulation of contestable developer services and relying more on market outcomes.

Given the available, albeit limited, information on the current status of competition in markets for contestable developer services in England and Wales, we consider that price controls or other forms of binding restrictions on incumbents' charges are likely to be needed in some form for all, or parts, of incumbents' contestable developer services during PR24, to achieve effective outcomes for all consumers within the sector.

The existing approach to regulation seeks to strike a balance between use of markets and price control regulation, but we do not consider a simple 'do-nothing' option – i.e., a decision to apply the same regulatory approach and methodology to developer services as applied at PR19 - should be Ofwat's starting point for PR24:

- Recent trends suggest that competition in contestable developer services is increasing. This might suggest that, even if not achievable in PR24, there is the prospect that Ofwat might over time rely more on the outcomes of markets than a more proactive regulatory approach via price control regulation.
- There may be ways in which Ofwat can improve outcomes for consumers via changes to the approach to regulation that might improve incentives for competition from incumbents as well as NAV and SLP providers of contestable developer services.
- The CMA was generally supportive of Ofwat's approach to assessing incumbents' costs associated with new developments at PR19. But this was a contentious area of the price review with concerns raised by some stakeholders, in particular incumbents, that the existing treatment of developer services may not always adequately permit incumbents to recover their efficient costs.

With improved data and time, there may be at least incremental improvements that can be made to the cost assessment at PR24 to address some or all of these concerns, particularly if there is increasingly evidence that the cost drivers for developer services vary considerably between companies. That is to say, even if the form of price control regulation of developer services was largely kept the same as for PR19, there may be ways that Ofwat can improve the implementation of its current policy.

As discussed in this report, there are a range of regulatory approaches and options that Ofwat might consider going forward that should help it to:

- set a more effective set of price controls at PR24; and/or
- potentially set a direction towards greater reliance on competition in developer services looking beyond the price review.

Our work suggests that Ofwat has two high-level strategic options that it should consider in formulating its strategy for PR24, each of which reflect different points on a spectrum of relying more or less on 'ex ante' (i.e., price controls) versus 'ex-post' (i.e., monitoring and enforcement) regulation of developer services:

- An evolution of the current approach, where all developer services would continue to be price control regulated within the scope of the network plus price control, potentially with a view to a further transition towards greater separate regulation or deregulation of developer services at future price controls.<sup>103</sup>
- A more fundamental change in the approach to regulating developer services at PR24 that would be more reliant on 'backstop' regulation of contestable developer services, akin to Ofgem's approach to regulating electricity new connections.<sup>104</sup>

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<sup>103</sup> Referred to as Option 1a in this report.

<sup>104</sup> Referred to as Option 2 in this report.

We also considered the option of Ofwat implementing a separate developer services price control, e.g., a separate revenue cap or price cap(s) for PR24 (referred to as Option 1b in this report).

There may be a number of benefits from a separate developer services price control, e.g., in terms of management focus and the transparency of the total incumbent cost base for developer services. But there would be considerable complexities of creating a separate control and practical challenges with its implementation. The alternative backstop form of price regulation may also provide a more flexible approach for Ofwat to regulate developer services and place greater reliance on market outcomes rather than price regulation over time.

For these reasons, we conclude that Ofwat should focus on other options than a separate developer services price control for PR24. However, Ofwat may wish to consult with stakeholders on this conclusion before reaching a definitive position. In particular, whether stakeholders consider a separate developer services price control would be an effective steppingstone to a more fundamental change in regulatory approach at PR29 given the transparency of cost allocation that the separate price control would bring.

The choice around what path to go down depends on the issues Ofwat then wants to prioritise in PR24 (and beyond) with regards to developer services regulation and which approach, on the balance of probabilities, is most likely to meet the long-term needs and interests of customers. We have set out within this report the key factors that we consider might help Ofwat reach an informed decision on this choice.

In isolation, and based on currently available information, Option 2 appears to be the more suitable ambition. Though it would require significant preparatory work ahead of PR24, in the long-term it offers the potential of a simpler approach to promoting customers' interests in contestable developer services.

However, this view is based on an uncertain assessment of the current state of the market. Ofwat is in the process of gathering richer data upon which to base this assessment, and some of its more recently introduced initiatives may have a further effect over time. Ofwat's final decision on which option to proceed with should take into account the opportunity cost of the preparatory work required, bearing in mind its other regulatory objectives.

Given that we find the merits of options 1a and 2 to be finely balanced, it may be that even if in isolation Option 2 is preferable, Option 1a is a proportionate approach.

In the immediate term, there are a number of practical steps that Ofwat can take to help reach a future decision and which we recommend that Ofwat seek to take forward during the next phase of the PR24 review:

- **Develop enhanced developer services cost allocation guidance.** Ofwat should consider developing and introducing more prescriptive developer services guidance for PR24 to ensure that incumbents are allocating costs to developer services both consistently and accurately.

This may inform the practicality of excluding certain contestable developer services from the wholesale network price controls (i.e., Option 2) where cost allocation rules are a necessity and/or help to support the evolution of the treatment of developer services within the cost assessment at PR24 (i.e., Option 1a).

- **Enhanced collection and use of developer services data.** This could enable Ofwat to conduct a more comprehensive 'state of the market' review. This may provide more confidence that an option that relies more on competition can be justified (i.e., Option 2).

Improvements in data (revenues, costs and mix of work/developments undertaken) may also be used to consider refinements to existing uncertainty mechanisms within the price control, e.g., the DSRA, and/or again to support the evolution of the cost assessment at PR24.<sup>105</sup>

Finally, Ofwat should consider how the depth of the charging boundary and the sharing of costs between new and existing customers interacts with each option. Ofwat is currently consulting on arrangements that would retain the existing 'semi-shallow' charging boundary (i.e., developers pay site specific plus local network reinforcement costs) but removes the income offset from PR24.

Assuming that these are the charging policies for the sector in PR24, Ofwat would need to consider:

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<sup>105</sup> For example, the treatment of expected different programmes of growth activity between incumbent areas during PR24.

- What the implications and issues would be, if any, of developer services charges contributing to both wholesale network plus allowed revenue and excluded services from the price control (if it chooses to adopt Option 2 at PR24)?
- For Option 2, what risks and unintended incentives could exist around the cost allocation and charge setting processes for incumbents if certain activities are excluded from the price control, while others continue to be included in the wholesale network plus price control?<sup>106</sup>

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<sup>106</sup> For example, if certain strategic reinforcement works are included in the network plus price control but are recovered directly from developers via infrastructure charges, would the treatment of the investment within the price control totex allowances create new incentives around cost allocation between price-controlled works and works excluded from the price control.

## Appendix A    **INSIGHTS FROM OTHER SECTORS**

Other sectors offer relevant insights into possible measures to facilitate greater competition in the developer services market. This section sets out insights from the electricity, gas and telecoms sectors that have assisted us in the development of options.

### **A.1.    ELECTRICITY CONNECTIONS IN GREAT BRITAIN**

In the electricity sector, developers and new connecting customers can choose to have contestable connections work undertaken by the distribution network operator (DNO, the incumbent electricity distributor), an independent distribution network operator (IDNO, similar to a NAV) or an independent connection provider (ICP, similar to an SLP in the water sector).

If a new connection is laid by an ICP, IDNOs can then bid to adopt those assets by offering an adoption payment to the ICP.<sup>107</sup> DNOs, by contrast, are unable to offer an adoption payment for new connections assets because of the restrictions of the price control.

During the DPCR5 price control review, Ofgem decided to introduce measures to remove regulatory barriers to competition and provide incentives for DNOs to support competition in the market for new electricity connections, as set out below.

#### **A.1.1. Opening up the market to competition**

Competition was first introduced into the electricity connections market in 2000. For “contestable work”, customers can choose to employ the DNO, an IDNO, or an ICP.

During the 2008 review of the distribution price control (“DPCR5”), Ofgem identified that competition in the market for new electricity connections was developing unevenly across the country. Under the then existing DPCR4 framework, any margin DNOs earned on competitive connections activities reduced the RAV, discouraging DNOs from earning a margin and making it difficult for new entrants to compete.<sup>108</sup>

Consequently, Ofgem decided to introduce measures to remove regulatory barriers to competition and provide incentives for DNOs to support competition in the market for new electricity connections, which included:

- **Allowing a four percent regulated margin on contestable connection services** for all DNOs in market segments where Ofgem considers competition to be viable.<sup>109</sup> To earn this margin, DNOs had to demonstrate, via an independent audit, that they had all the relevant systems and processes to accurately record connections’ guaranteed standards of performance and connections-related price control data. DNOs also had to commit to make guaranteed standards payments to all types of customers.
- **Requiring DNOs to pass competition tests for their Relevant Market Segments (RMSs) by December 2013.** DNOs who could meet the tests earlier than December 2013 could submit their case at any time. Figure A.1 illustrates the outcomes of various test results.

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<sup>107</sup> NAVs are able to do the same in the water sector, which may explain why Ofwat has started to see increasing number of NAV applications working with SLPs.

<sup>108</sup> Source: Ofgem, 2008. Electricity Distribution Price Control Review Policy Paper. Available [here](#).

<sup>109</sup> The 4% margin was based on the average margin across a sample of electrical contractors (3.3%) with an average standard deviation of 4.9%. The margin was defined as net operating income plus fixed asset depreciation and amortisation divided by net sales.

Figure A.1: Consequences of passing or failing Ofgem competition tests



Source: Ofgem

Ofgem established nine market segments in which they considered competition in connections was viable (i.e., relevant market segments), and two market segments in which they considered competition in connections was not viable (i.e., excluded market segments), as set out below:

Table A.1: Ofgem excluded market segments

Excluded market segments	
LVSSA	Low voltage (LV) connection activities relating to no more than four domestic premises or one-off industrial and commercial work (i.e., one to four houses).
LVSSB	Connection activities in respect of a connection involving three-phase whole current metering at premises other than domestic premises (i.e., one off LV connections).

Source: Ofgem

Table A.2: Ofgem relevant market segments

Relevant market segments	
Metered demand connections	LV work – LV connection work involving only LV work, other than in respect of the excluded market segments.
	High voltage (HV) work – LV of HV connection activities involving HV work (including where that work is required in respect of connection activities within an excluded market segment).
	HV and extra HV (EHV) work: LV or HV connection activities involving EHV work.
	EHV work and above: EHV and 132kV connection activities.
Metered distribution generation (DG)	LV work: LV connection activities involving only LV work.
	HV and EHV work: any connection activities involving work at HV or above.
Unmetered connections	Local authority (LA) work: new connection activities in respect of LA premises.
	Private finance initiatives (PFI) work: new connection activities under PFIs.
	Other work: all other non-LA and non-PFI unmetered connections work.

Source: Ofgem

The competition tests examined various metrics including market share, penetration and price, and evaluated other evidence such as customer awareness of competitive alternatives, facilitation of competition, complaints to Ofgem / Ombudsman, and compliance with regulatory standards.<sup>110</sup>

At the end of the competition test process in April 2014, Ofgem concluded that **effective competition existed in 42 of the 126 RMSs**.<sup>111</sup> In its 2015 review of the electricity connection market, Ofgem determined that many of the outstanding issues related to the DNOs' role in the connection process. In April 2016, to encourage DNOs to change their processes and to harmonise arrangements for competition, Ofgem introduced an **enforceable code of practice (CoP)**.<sup>112</sup>

<sup>110</sup> Source: Ofgem, 2008. Electricity Distribution Price Control Review Policy Paper Supplementary Appendices. Available [here](#).

<sup>111</sup> Source: Ofgem, 2014. Completion of the Competition Test Process. Available [here](#).

<sup>112</sup> Energy Networks Association, 2016. Competition in Connections Code of Practice. Available [here](#).

DNOs are also subject to the Incentive on Connections Engagement (ICE)<sup>113</sup> across both contestable and non-contestable connections activities. The ICE requires an annual submission to Ofgem covering the DNO's strategy for engagement with connection stakeholders and assessment of its performance relative to various key performance indicators and targets. Ofgem can issue the DNO with a penalty should it determine that the DNO has failed to meet the assessment criteria.

### A.1.2. Measures for non-competitive segments

At DPCR5, Ofgem also strengthened regulation for customers that choose the non-competitive connections route and for segments of the connections market where competition is undeveloped or unlikely to develop, including:

- **Guaranteed standards of performance and a licence condition** to improve the accuracy of connections quotations and reduce the time taken to deliver connections, for all customers.
- **A price accuracy scheme** for customers with up to four small service connections, to enable customers to challenge the DNO over the price they are quoted. A similar scheme exists in the gas connection market.

At RIIO-ED1, Ofgem introduced **incentives to improve service quality** in non-competitive connections: customer satisfaction survey and 'time to connect' incentives for minor connections customers, and a connections engagement incentive for major connections customers.<sup>114</sup>

### A.1.3. Price control treatment of sole use connections

Under DPCR4, all connections costs were treated in the same way and added to the RAV, net of any customer contributions. For DPCR5 and RIIO-ED1, Ofgem changed their approach to prevent DNOs and customers exposed to a disproportionate share of costs through over- or under-recovery. The new approach is described in Table A.3.

Table A.3 Price control treatment of connections expenditure by DNOs.

Component of expenditure	Price control treatment
Sole-use assets funded by connecting customer	Excluded from price control. Contestable parts subject to 4% regulated margin.
Network reinforcement funded by connecting customer	Excluded from price control. Not subject to margin.
Network reinforcement funded by other users	Included in price control. Allowed revenues adjust according to number of connections. Large connections are covered by an integrated general reinforcement / large one-off connection reopener.

Source: Ofgem

If reinforcement is required directly because of a new development (e.g., a new substation), the developer would pay the full cost of the works needed (i.e., network reinforcement funded by connecting customer). This may lead to them paying for infrastructure beyond what is needed to meet its own requirements in order to get a connection. The 'second-comer' rule was introduced to overcome the incentive on developers to wait for others to invest first by allowing a payment from followers (connecting within 10 years) to first movers, but a number of limitations have been identified with this rule<sup>115</sup>.

## A.2. GAS CONNECTIONS IN GREAT BRITAIN

### A.2.1. Connection providers

In the UK gas market, gas distribution networks (GDNs), utility infrastructure providers (UIPs) and licensed independent gas transporters (IGTs) all compete to provide new connection services. Over half of new and

<sup>113</sup> Source: Ofgem. Incentive on Connections Engagement Guidance document. Available [here](#).

<sup>114</sup> Source: Ofgem, 2013. Strategy decision for the RIIO-ED1 electricity distribution price control. Outputs, incentives and innovation. Available [here](#).

<sup>115</sup> Source: National Infrastructure Commission, 2020. Infrastructure to support housing. Available [here](#).

modified gas connections are carried out by non GDNs.<sup>116</sup> Similarly to the electricity sector, gas distribution networks (GDNs) are obliged to offer to connect new gas customers under the Gas Act 1986. However, if the GDN determines that the new connection would compromise its ability to maintain an efficient and economical gas pipeline system, the GDN can refuse to provide the connection.<sup>117</sup>

## A.2.2. Charging for a new connection

The methodology which GDNs and IGTs use to calculate connection charges must be approved by Ofgem and published on the company's website. The costs of the new connection are shared between the connecting customer and the wider user base: if a domestic customer requests a connection within 23 metres of existing GDN pipelines, the first ten metres are paid for by network users and the remainder by the connecting customer. There is no income offset. Any required network reinforcement is generally not charged to the connecting consumer.<sup>118</sup>

## A.2.3. Price control treatment

All connections costs incurred by the GDNs are treated in the same way and added to the RAV, net of any customer contributions on an outturn basis.

## A.2.4. Quality of service

As in the electricity sector, Ofgem has implemented a set of **guaranteed standards of performance** and a **quotation accuracy scheme**, whereby GDNs and IGTs must compensate a connecting customer if they fail to meet certain standards or if they provide an inaccurate quotation. The standards were introduced into both the Gas (Standards of Performance) Regulations 2005 and GDNs' Standard Special Licence Condition D10 in 2005.

## A.3. TELECOMS

In the UK, new telecoms connections are generally provided by Openreach, alongside other infrastructure providers, including Virgin. Openreach serves more than 500 UK internet service providers and phone providers and operates independently from the rest of the BT Group, in order to provide equal access to BT's local access network. In contrast to water, Openreach do not have an obligation to offer a connection to its network.

Ofcom uses an ex-post approach to the regulation of Openreach, having established the Openreach Monitoring Unit (OMU) in 2017 to assess whether the new rules are being observed. The costs of new telecoms connections are shared between the wider customer base and the connecting customer, depending on the size of the development<sup>119</sup>, as shown in the table below.

Table A.4: Developer charges for new broadband connections, by development size

Number of plots	Cost to developer
1	Depends on situation, and whether a copper or fibre connection is required.
2-19	If fibre to the premises (FTTP) costs lower than fibre to the cabinet (FTTC), FTTP is provided free of charge to the developer. Else, FTTC is provided free of charge and FTTP can be provided with an additional contribution from the developer.
20+	FTTP installed at no cost to developer.

<sup>116</sup> Source: Ofgem. Competition in connections. Available [here](#).

<sup>117</sup> Source: Ofgem. How do I obtain a one-off domestic gas connection? Available [here](#).

<sup>118</sup> Ofgem (2012). Connections Industry Review 2010-11. Available [here](#).

<sup>119</sup> Openreach, 'Registering your site'. Available [here](#).

## Appendix B ANNUAL CONTESTABILITY SUMMARY

The template for companies' Annual Contestability Summary (ACS) was set out in companies' published guidance in relation to the adoption of self-laid assets by water companies in England. The template aims to serve as the minimum number of contestable activities, with the scope of activities available for SLPs to undertake increasing over time:

- Activities shaded in green can be performed by SLPs are always contestable.
- Activities shaded in amber can also be performed by SLPs, but the water company may require additional evidence to demonstrate competence.
- Activities highlighted in red are of such high risk that are unlikely to be contestable in most circumstances.

Anecdotal evidence from stakeholder engagement has indicated that close to 100 percent of site-specific developer services work is contestable.

Table B1: Template Annual Contestability Summary

	Water categories by number of properties potentially affected by work or strategic nature of existing work			
	<49	50-199	200-499	500+/Strategic main
Selection of a proposed POC to serve a Site/Development from records of Existing Mains	Green	Green	Green	Green
Construction of new mains and service connections	Green	Green	Green	Green
Construction of new mains as part of Network Reinforcement or associated Site diversion work	Green	Green	Green	Green
Design of new water network	Green	Green	Green	Green
Chlorination and pressure testing of Self-lay Works	Green	Green	Green	Green
Meter installation in conjunction with new service connections	Green	Green	Green	Green
Undertaking Water Quality samples	Green	Green	Green	Green
Analysing Water Quality samples	Green	Green	Green	Green
Construction of routine mains connections	Green	Green	Green	Green
Main and/or service connection: up to 63mm PE/Barrier pipe	Green	Green	Green	Amber
Connection: 63mm to 300mm PE / Barrier Pipe	Amber	Amber	Amber	Amber
Connections: over 300mm	Amber	Amber	Amber	Amber
Valve operation in relation to commissioning new Self-Lay Works	Amber	Amber	Amber	Amber
Self-certification of SLP for Site water distribution systems designs	Amber	Amber	Amber	Amber
Any size connection to GRP / PVC Network	Red	Red	Red	Red
Design of Network Reinforcement and/or design of Network diversion(s)	Red	Red	Red	Red
Pipe sizing criteria, and the approval of design by others	Red	Red	Red	Red
Assessment of network risk, & operating live network	Red	Red	Red	Red
Commission telemetry links (meters / field equipment)	Red	Red	Red	Red
Connection, commissioning and/or decommissioning of diverted Network	Red	Red	Red	Red

Source: Water UK, 2020. Water Sector Guidance in relation to the adoption of self-laid assets by Water Companies in England.



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