

July 2022

Creating tomorrow, together:
consulting on our methodology for PR24

Appendix 3 - Developer services

About this document

This appendix sets out further detail of our proposed approach to regulating developer services at PR24 that is set out in Chapter 3 of our consultation document. It reflects on the views expressed by stakeholders in response to our [May 2021 discussion document](#).

We present separate option assessments for network reinforcement, wastewater site specific developer services, and water site specific developer services given the different market conditions for each of these services currently. When assessing options, we have considered the general statutory duties for most of our work set out in section 2 of the Water Industry Act 1991.¹ This includes the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition, and our secondary duty to contribute to the achievement of sustainable development.

Some of the options discussed in this appendix would require licence modifications. Where needed, we will consult on licence modifications after publication of the final methodology.

Our proposed approach is consistent with the UK government's strategic policy statement (SPS)² which expects Ofwat to:

- promote greater collaboration between incumbents and their new connections customers, particularly on large-scale developments;
- improve fairness and transparency in incumbents' charging arrangements and further promote sustainability and environmental protections; and
- consider how its regulatory framework can enable water and wastewater services to support government's ambitions to increase housing supply, in line with its duty to contribute to the achievement of sustainable development.

Our proposed approach is also consistent with the Welsh Government's strategic priorities, which expect Ofwat to keep under review our approach to developer services to ensure it is fit for purpose to support economic development in Wales.

Following the executive summary, this appendix is structured as follows:

- Learning from developer services regulation at PR19
- State of competition in developer services
- Proposed approach to regulating network reinforcement
- Proposed approach to regulating wastewater site-specific developer services
- Proposed approach to regulating water site-specific developer services
- Other developer services issues
- Consultation questions

¹ UK government, '[Water Industry Act 1991](#)', section 2.

² UK government, '[The government's strategic priorities for Ofwat](#)', updated 28 March 2022.

Summary

Developer services describe the activities delivered to connect new developments to the water and/or wastewater network and can be broken down into site specific developer services and network reinforcement.

Network reinforcement work is mostly delivered by the incumbent water companies. But site-specific developer services activities are mostly contestable and can be provided by the incumbent water company, a self lay provider or a new appointee. Self lay providers and new appointees can provide faster, more responsive services and lower prices than the incumbent water company.³ They can also sometimes provide developer services across utilities, reducing coordination issues.⁴

For the 2019 price review (PR19), revenue from developer services customers and water customer bills are included in the wholesale water and wastewater network plus total revenue controls. We said we would revisit our regulation of developer services at the 2024 price review (PR24).

To enable us to arrive at appropriate proposals, we have collected more granular data to better assess the state of competition in developer services. We have also reviewed our current approach to developer services regulation.

We have subsequently developed our proposed approach to regulating developer services at PR24, and taken into account stakeholder responses to the high level options we presented in our May 2021 discussion document.⁵⁶

Network reinforcement

We propose that network reinforcement remains in the wholesale water and wastewater network plus controls because:

- It is almost entirely delivered by the incumbents, so competition is insufficient to protect developer services customers from potential monopoly power (eg higher prices).
- There are substantial interactions with other water company activities (eg capital maintenance) that do not facilitate accurate cost separation.
- There can be a substantial timing differences between when costs are incurred and revenue received, because reinforcement may commence before work begins on the development site.

³ Ofwat, '[Review of incumbent company support for effective markets](#)', August 2020. Page 30–31.

⁴ Ibid.

⁵ Ofwat, '[PR24 and beyond: Creating tomorrow, together](#)', May 2021.

⁶ For avoidance of doubt, we envisage that the developer services measure of experience (D-MeX), Ofwat's charging rules, and Code for Adoption Agreements remain under all options.

We are interested in stakeholders views on whether:

1. to apply a revenue reconciliation mechanism to network reinforcement investment requirements at PR24 to account for differences between forecast and outturn demand for developer services; or
2. if cost sharing is sufficient.

Wastewater site-specific developer services

We propose that wastewater site-specific developer services are excluded from the wastewater network plus price control because:

- Nearly all wastewater site-specific developer services are delivered by self lay providers or the housing developer. There appears to be no market power issue.
- Costs and revenue can be separately identified because of limited interactions with other activities and collection of more granular data in the annual performance report.

There are some instances where developer customers must use the incumbent wastewater company to provide wastewater site-specific developer services (eg on sites with access issues such as the need to cross a railway, where the incumbent needs to use its statutory powers). We will consider ahead of the PR24 final methodology whether any changes to charging rules are needed to protect customers in these instances.

Water site-specific developer services

We see benefits in removing water site-specific developer services from the network plus price controls – it reduces the risk of cost cross-subsidisation with water bill payers and subsequent market distortions; and removes the need for complex cost assessment and reconciliation mechanisms. But we must make sure that developer services customers are sufficiently protected in instances of potential monopoly power.

Our analysis shows relatively strong competition for new developments of more than 25 properties from third parties. But weak competition for smaller new developments (25 properties and less). We therefore consider a mix of markets and regulatory tools are required at PR24 to achieve effective outcomes in relation to water site-specific developer services.

We propose to exclude new developments of more than 25 properties from the water network plus price control at PR24. We also propose to introduce transitional arrangements for companies with low levels of third-party activity in this market segment (eg only allow companies to increase developer charges in line with the consumer prices index including housing costs (CPIH)). If we proceed with this proposal, we will consult separately on what transitional arrangement there should be.

We propose that new developments of 25 properties and below should either:

1. remain in the wholesale water network plus control; or
2. be removed from the wholesale water network plus control but with alternative protections to protect developer services customers in this market segment from potential monopoly power (eg higher prices).

We are interested in stakeholder views on the relative merits of each of these options, and how we could achieve suitable customer protection through alternative non-price-control protections (eg through changes to our charging rules or an ex-post reconciliation).

Other developer services issues

We also regulate developer services provided by English water companies through our Charging Rules for New Connection Services (English Undertakers).⁷ The rules apply to companies that operate wholly or mainly in England. These set out how English water companies⁸ should set and present their charges for new connection services. But the framework for setting new connection charges that applies to Welsh water companies currently remains set out in the Water Industry Act 1991, rather than in charging rules.

We have made several important changes to the way English water companies charge for developer services since 2018. Our changes have supported the developer services market by improving the way companies set out their charges and making them more cost reflective. This has allowed self lay providers and new appointees to compete on level terms with incumbent water companies, and given developers and third parties greater opportunity to exercise their choices.

An important change to the way we regulate developer services is our decision to stop English water companies offering income offsets and to remove the balance of charges rule from April 2025.^{9,10} We concluded that there is no convincing justification for income offset, and that any discount or surcharge reflecting environmental or social issues should have a clear rationale.

The issue of developers paying for nutrient neutrality credits is discussed in [Appendix 9 – Setting expenditure allowances](#).

⁷ Ofwat, '[Charging rules for new connection services](#)', October 2021.

⁸ Water companies whose areas of appointment are wholly or mainly in England.

⁹ See [Scope and balance of developer charges and incentives - conclusions - Ofwat](#), October 2021.

¹⁰ Welsh companies will continue to apply the income offset discount to requisitions of new water mains & sewers.

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1. Introduction

1.1 Background

Developer services describes the activities delivered to connect new developments to the water and/or wastewater network. There are around 200,000 new connections every year across England and Wales. Developer services revenue accounted for 4.4% of network plus allowed revenue at PR19.¹¹

Developer services can be broken down into site-specific and network reinforcement work:

- **site-specific developer services** – new connections, water mains and sewer requisitions, and water mains and sewer diversions; and
- **network reinforcement** – the provision or upgrading of network assets such as distribution and trunk water mains, foul, combined and surface water only sewers, and pumping and storage facilities, to provide for new customers with no net deterioration of existing levels of service.

Network reinforcement work is mostly delivered by the incumbents. But site-specific activities are mostly contestable and can be provided by the incumbent, a self lay provider¹², or a new appointee.¹³ Self lay providers and new appointees can provide faster, more responsive services and lower prices than incumbents.¹⁴ They can also sometimes provide developer services across utilities, reducing coordination issues.¹⁵

Our PR19 approach to developer services included several elements, as summarised below:

- **Developer services revenue included within scope of wholesale network plus revenue controls (ie in the single till).** This means that an unexpected increase in developer services revenue must be offset by a decrease in wholesale charges to comply with the total revenue cap. This aims to prevent water companies from over charging developers and drive cost efficiencies.

¹¹ Ranging between 2% (YKY) and 9% (AFW) of network plus allowed revenue across companies.

¹² If a development requires a new water main or sewer, the developer may ask the water or sewerage company to install the pipework. Alternatively, it can choose its own contractor to do the work, which is known as self-lay (ie self lay provider). The water company takes over responsibility for (adopts) self-laid pipes that meet the terms of its agreement with the developer or self lay provider that carries out the work.

¹³ New appointees are companies that have successfully applied for an appointment or an area variation to replace the existing water and or sewerage company at a particular site.

¹⁴ Ofwat, '[Review of incumbent company support for effective markets](#)', August 2020. Page 30-31.

¹⁵ Ibid.

- **Developer services costs were assessed alongside base costs¹⁶ rather than on their own.** This was largely because of data limitations (eg the absence of separate reporting of developer services cost information).
- **Developer services revenue is included in the revenue forecasting incentive (RFI).** This aims to incentivise companies to engage with developers and accurately forecast developer services demand when setting charges each year.
- **Developer services measure of experience (D-MeX) was introduced** to incentivise water companies to provide an excellent customer experience to developers, self lay providers and new appointees.
- **A developer services revenue adjustment (DSRA) mechanism was introduced.** This adjusts allowed network plus revenue if the actual number of connections is more or less than forecast (using a weighted average unit rate).
- **Developer services costs are excluded from cost sharing** to make sure water companies have an incentive to deliver cost efficiencies like self lay providers and new appointees.¹⁷

We also protect the needs and interests of developers, self lay providers and new appointees through:

- **Charging Rules for New Connection Services (English Undertakers)** – these set out how English water companies should set and present their charges for new connection services.
- **Code for Adoption Agreements (English Undertakers)** – this sets out the minimum levels of service English water companies must provide to self lay providers and the actions they must take if they fail to deliver the minimum levels of service (eg a fee refund).
- **Dispute determination powers under the new connections charging regime for Welsh water companies** – like English companies, Welsh companies have a duty to allow, and the right to charge for, new connections. Currently the framework for setting these charges remains set out in the Water Industry Act 1991, rather than in charging rules.

We said we would revisit our regulation of developer services at PR24.¹⁸

1.2 Progress since PR19

In [our May 2021 discussion document](#), we set out three potential options for developer services at PR24:

- **An adaption of the current regulatory approach**, where all developer services continue to be included within the network plus price controls;
- **A separate price control for site-specific developer services**; and

¹⁶ Base costs are routine, year-on-year costs that companies incur in the normal running of their business to provide a base level of good service to customers and the environment and maintain the long-term capability of assets.

¹⁷ But any difference between developer services costs and revenue would go through cost sharing.

¹⁸ Ofwat, '[Delivering Water 2020: Our final methodology for the 2019 price review](#)', December 2017, page 96.

- **A more fundamental change in the approach to regulating developer services that would be more reliant on 'back stop' regulation of site-specific developer services.**

From the stakeholders that commented on the three options, incumbent water companies were mostly supportive of a backstop regulation approach or deregulation entirely. Only Thames Water supported a separate control, and Bristol Water did not think any changes were required. Independent Water Networks Limited (IWNL), a new appointee, proposed that incumbent water companies should demonstrate they have met four conditions before removing price control regulation: (i) consistently high levels of service; (ii) availability of reasonable margins to allow new appointees to compete; (iii) removal of regulatory obstacles that preclude a level playing field; and (iv) sufficient competition.

To help inform our decision on how to regulate developer services at PR24, we have since:

- [published more prescriptive guidance in relation to overhead cost allocation](#), which should improve the comparability of developer services cost information between companies; and
- [collected more granular developer services data](#) that has enabled us to better analyse and assess the state of competition in developer services.

We have used our analysis of the granular developer services data to inform our proposed approach to regulating developer services at PR24, as set out in Chapter 3 of our consultation document.

2. Learning from developer services regulation at PR19

The inclusion of developer services in the single till creates wholesale bill volatility and potential cost cross subsidisation with the general customer base

The aim of including developer services in the single till was to protect developers from incumbent water companies over-charging them, particularly those with limited choice. But it can lead to some negative consequences:

- **Water bill volatility** – developer services revenue is included in the single till. So, an increase in developer services revenue requires a reduction in revenue recovered from water customers. This reduces water bill predictability. But the impact is likely to be relatively small (eg a 20% increase in site-specific developer services revenue would require a 1% decrease in water network plus bills on average).
- **Potential cost cross subsidisation with the general customer base** – companies could use the revenue protection offered by the single till to set developer services charges too low, preventing effective competition from other companies. Charging rules should go some way to prevent this as charges are required to be cost reflective.
- **Water companies may be unable to recover efficient costs** associated with developer services activity that was not forecast when cost allowances were set at the price review. An ex-post revenue reconciliation mechanism can help to resolve this issue by adjusting allowed revenue based on the difference between forecast and actual volume and mix of developer services work, but may not completely.

Assessing site specific developer services costs is very challenging

Our regulatory approach should allow water companies to recover efficient site-specific developer services costs. Cost recovery uncertainty may discourage incumbent water companies from connecting new developments in a timely way (ie delaying work until the next regulatory period).

At PR19, we assessed developer services costs with base costs because of data limitations (eg developer services costs were not collected, and limited cost driver information was available). This approach made it challenging to identify the developer services cost allowance, or whether we had set it appropriately. Setting cost allowances too high or low risks distorting the market if companies use this information to set developer charges.

For PR24, we have more information available to forecast efficient developer services costs. We now collect developer services costs separately from other costs and collect more cost driver information. We have also improved overhead cost reporting guidance, which should improve developer services cost reporting consistency between companies.

Despite the additional data collection, developer services costs tend to be more difficult to assess than other costs because they depend on when new developments occur and the

types of new developments. Both of which are outside of company control. These factors vary more than the drivers of other water company activities, which makes it challenging to accurately forecast efficient developer services costs for each company. The cost assessment challenge is demonstrated by the very large range in water site-specific developer services unit costs, ranging from £1,157 to £4,379 per connection in 2020-21.

Incumbent water companies can be financially rewarded for connections work delivered by self lay providers and new appointees

The DSRA adjusts allowed developer services revenue within the total revenue control using a single, average unit rate per connection if the actual number of new properties is more or less than the PR19 forecast. It was introduced at PR19 to encourage timely and quality new connections by mitigating volume risk and reducing cost recovery uncertainty (ie discouraging incumbent water companies from delaying new connections work until the next regulatory period).

The revenue adjustment is neutral to which party delivers the services (incumbent, self lay provider or new appointee). So, incumbent water companies can benefit financially from connections completed by other providers because their revenue is unaffected, but costs are avoided. This should encourage incumbent water companies to facilitate competition in the market (eg timely provision of information to self lay providers; promoting the self-lay option). But it also means that developers pay self lay providers or new appointees (instead of incumbent water companies) for delivering the work, and end customers also pay incumbents for work they lost to self lay providers or new appointees and did not deliver.

The DSRA does not account for in-period changes in the work-mix

The use of a single unit rate in the DSRA means companies bear the risk that the mix of work undertaken is different to that forecast. This may mean that companies are not able to recover efficient costs if they deliver more complex developer services work than planned. And conversely, they would over-recover costs if they deliver less complex work than planned. This creates an incentive to give away more costly development sites to self lay providers and new appointees.

Work-mix risk is present for all activities undertaken by companies. But is arguably more problematic for developer services given the work mix is driven by new development types, which is outside of company control.

3. State of competition in developer services

We collected granular developer services data from water companies in late 2021 to better understand the state of competition in developer services. The key findings of our analysis are below, alongside findings from the CEPA¹⁹ and SIA Partners²⁰ studies that were conducted in early 2021. This analysis excluded new connections to new appointees' networks, thereby understating the level of competition in developer services.

Almost all wastewater site-specific developer services are delivered by developers / self lay providers

- 98% of sewer connections are completed by developers / self lay providers instead of incumbents according to the granular data received from incumbents in late 2021.

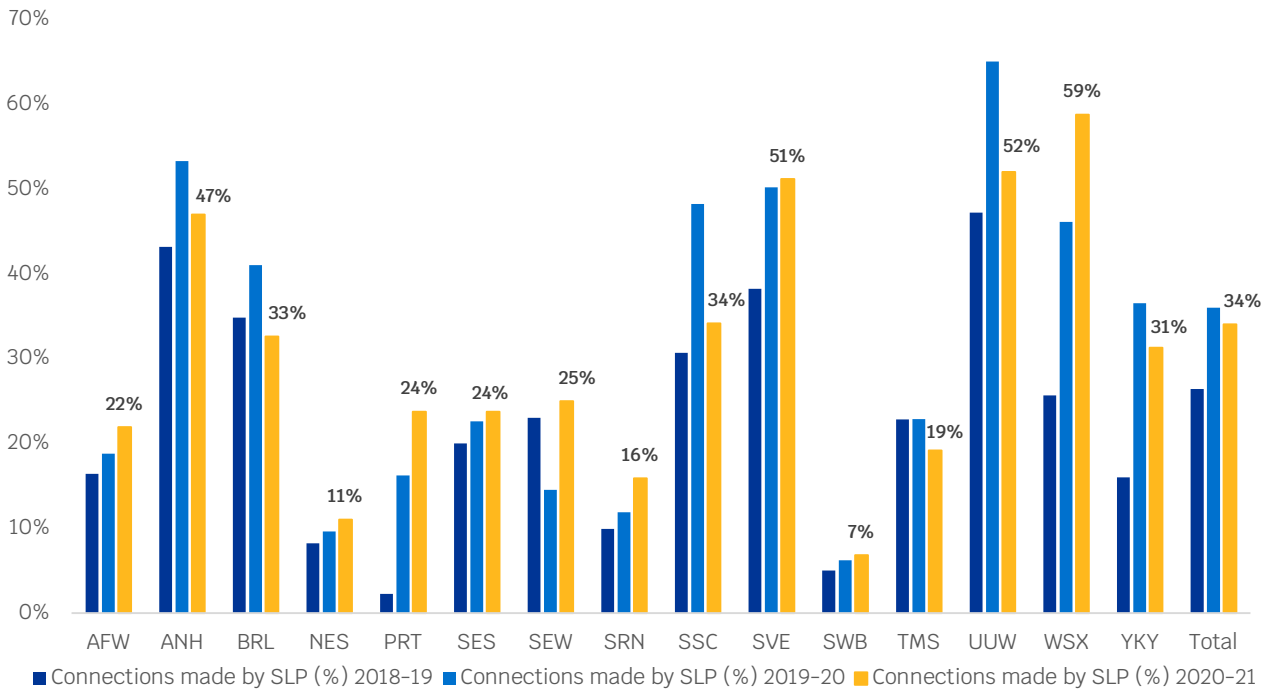
The amount of water site-specific developer services work delivered by self lay providers is growing. But remains limited in some regions and market segments

- The overall level of self lay provider activity is growing. There are now over 100 self lay providers delivering water site-specific developer services across England and Wales. And water connections made by self lay providers increased from 26% to 34% between 2018-19 and 2020-21 (see Figure 3.1).
- Incumbent water companies face active competitive pressure from self lay providers in some regions of England and Wales, and for certain types of new developments.
- The percentage of new water connections completed by self lay providers ranged from ~7% (South West Water), ~11% (Northumbrian Water), ~16% (Southern Water) to ~51% (Severn Trent England), ~52% (United Utilities) and ~59% (Wessex Water) in 2020-21 (see Figure 3.1).
- Self lay providers conduct most work on developments that need new water mains. 53% of new water mains were laid by self lay providers in 2020-21 (see Figure 3.2).
- Self lay providers generally do not work on new developments that do not require new water mains. These new developments accounted for ~40% of new properties in 2020-21. The need for new water mains also increases with development size.
- The proportion of work undertaken by self lay providers increases with development size. Self lay providers connect a similar number of new properties when the size of the development surpasses 25 properties (see Figure 3.3, Figure 3.4, Table 3.1 and Table 3.2).

¹⁹ CEPA, '[Approach to the regulation of developer services at PR24](#)', 24 May 2021

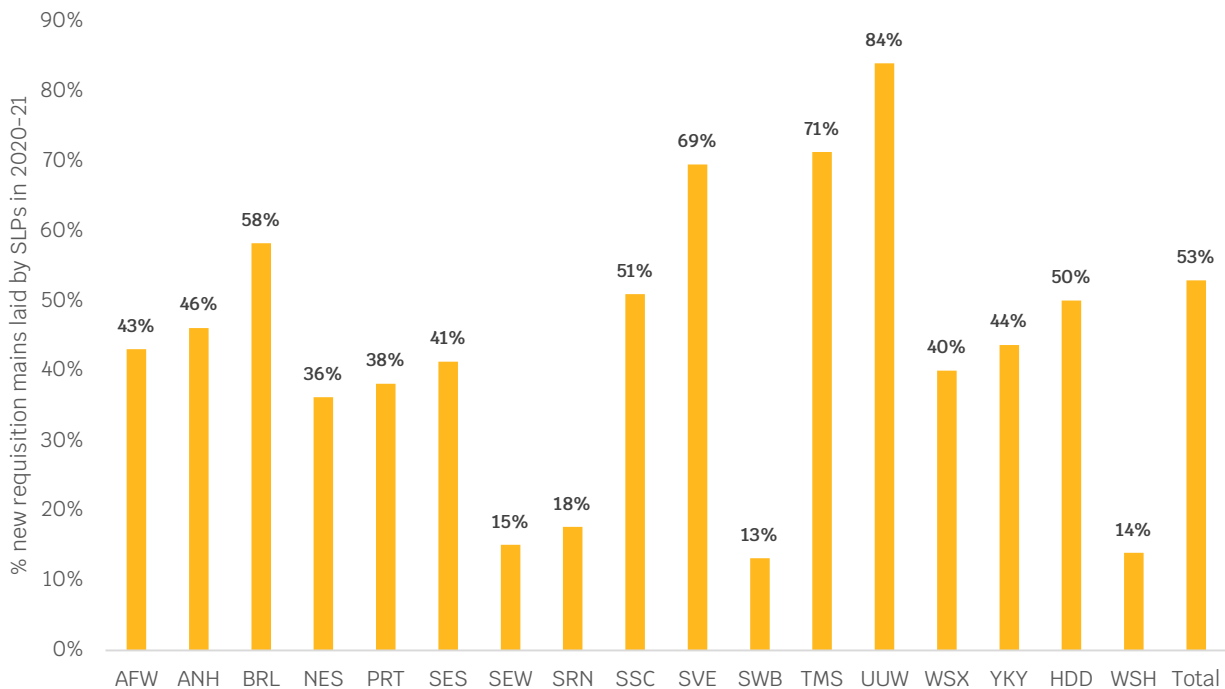
²⁰ SIA Partners, '[Connection charges for developer services in England – root cause analysis](#)', August 2021.

Figure 3.1: water connections made by self lay providers (%) 2018-19 to 2020-21



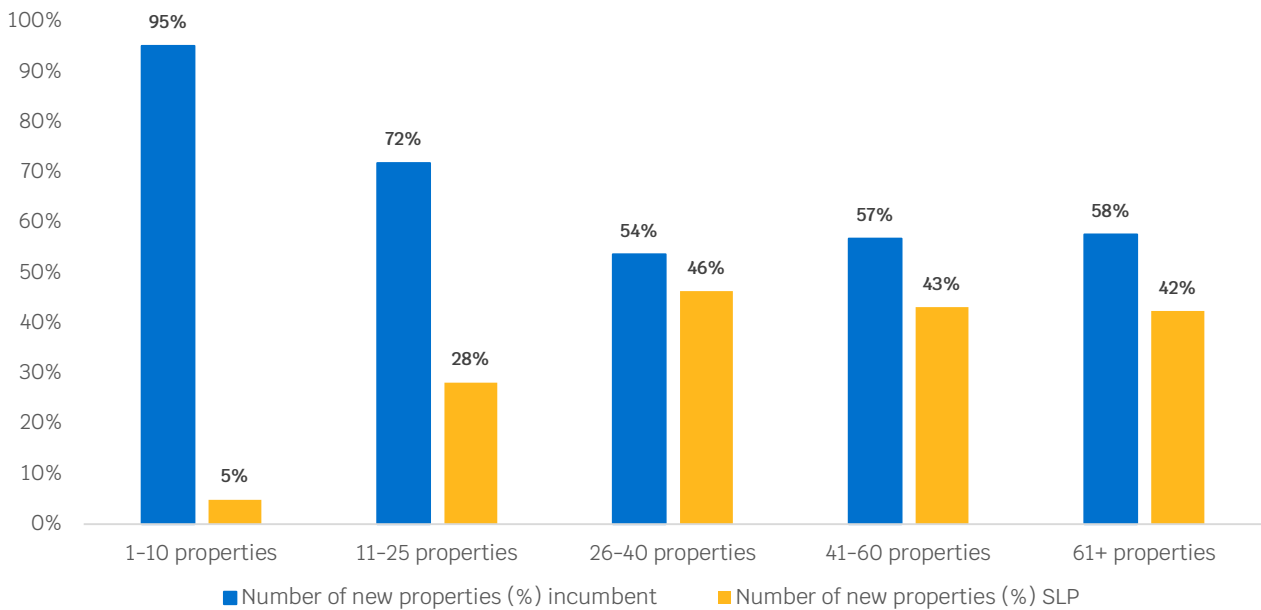
Source: SIA Partners. '[Connection Charges for Developer Services in England. Root Cause Analysis](#)'. August 2021.

Figure 3.2: new water mains laid by self lay providers in 2020-21 (% of total)



Source: Ofwat analysis of 2020-21 Annual Performance Report (APR) data

Figure 3.3: Percentage of new properties connected by incumbents versus self lay providers by development size in 2020-21 (all financially closed new developments)



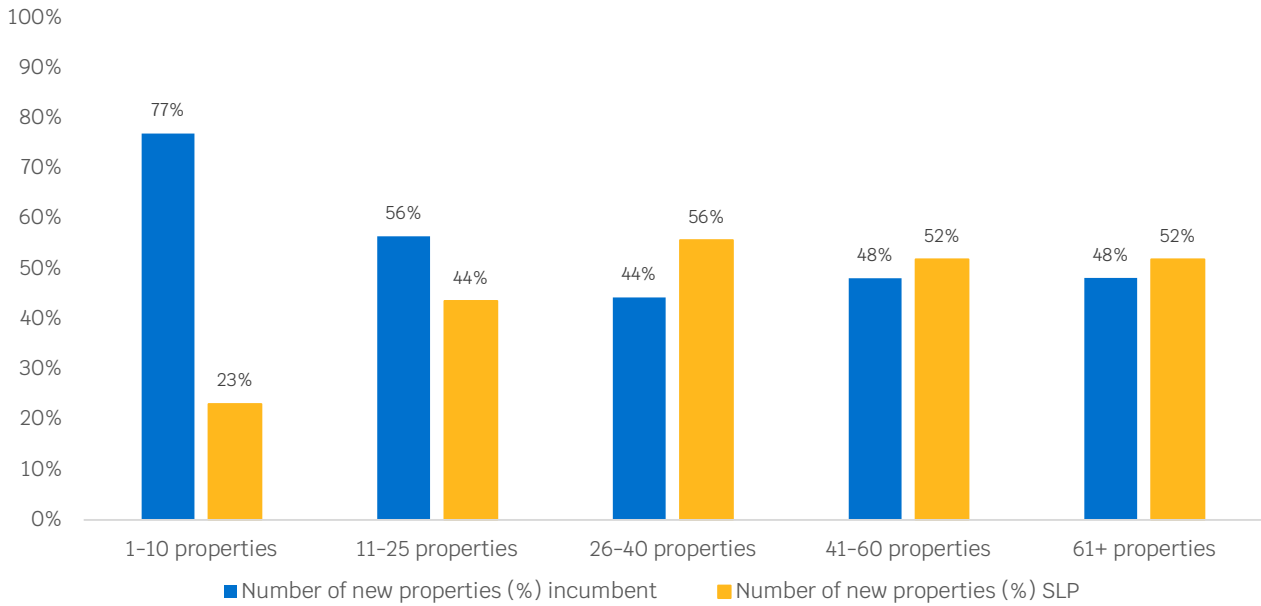
Source: Ofwat analysis of granular 2020-21 developer services data (financially closed new developments).

Table 3.1: Percentage of new properties connected by self lay providers by development size in 2020-21 (all financially closed new developments)

	1-10 properties	11-25 properties	26-40 properties	41-60 properties	61+ properties
Affinity Water (AFW)	3%	5%	0%	16%	38%
Anglian Water (ANH)	9%	42%	63%	58%	74%
Bristol Water (BRL)	12%	44%	68%	62%	29%
Hafren Dyfrdwy (HDD)	0%	0%	n/a	0%	n/a
Northumbrian Water (NES)	2%	8%	14%	13%	6%
Portsmouth Water (PRT)	0%	0%	0%	0%	0%
SES Water (SES)	0%	0%	65%	0%	0%
South East Water (SEW)	0%	n/a	n/a	n/a	n/a
South Staffs Water (SSC)	5%	21%	100%	100%	100%
Severn Trent Water (SVE)	0%	9%	13%	57%	37%
South West Water (SWB)	0%	0%	0%	0%	0%
Thames Water (TMS)	6%	28%	43%	26%	7%
United Utilities (UUW)	12%	48%	71%	74%	82%
Dŵr Cymru (WSH)	20%	27%	20%	29%	16%
Wessex Water (WSX)	1%	6%	34%	32%	n/a
Yorkshire Water (YKY)	1%	19%	28%	15%	45%

Source: Ofwat analysis of granular 2020-21 developer services data (financially closed new developments).

Figure 3.4: Percentage of new properties connected by incumbents versus self lay providers by development size in 2020–21 (all financially closed new developments that require new requisition mains)



Source: Ofwat analysis of granular 2020–21 developer services data (financially closed new developments that required new requisition mains).

Table 3.2: Percentage of new properties connected by self lay providers by development size in 2020–21 (all financially closed new developments that require new requisition mains)

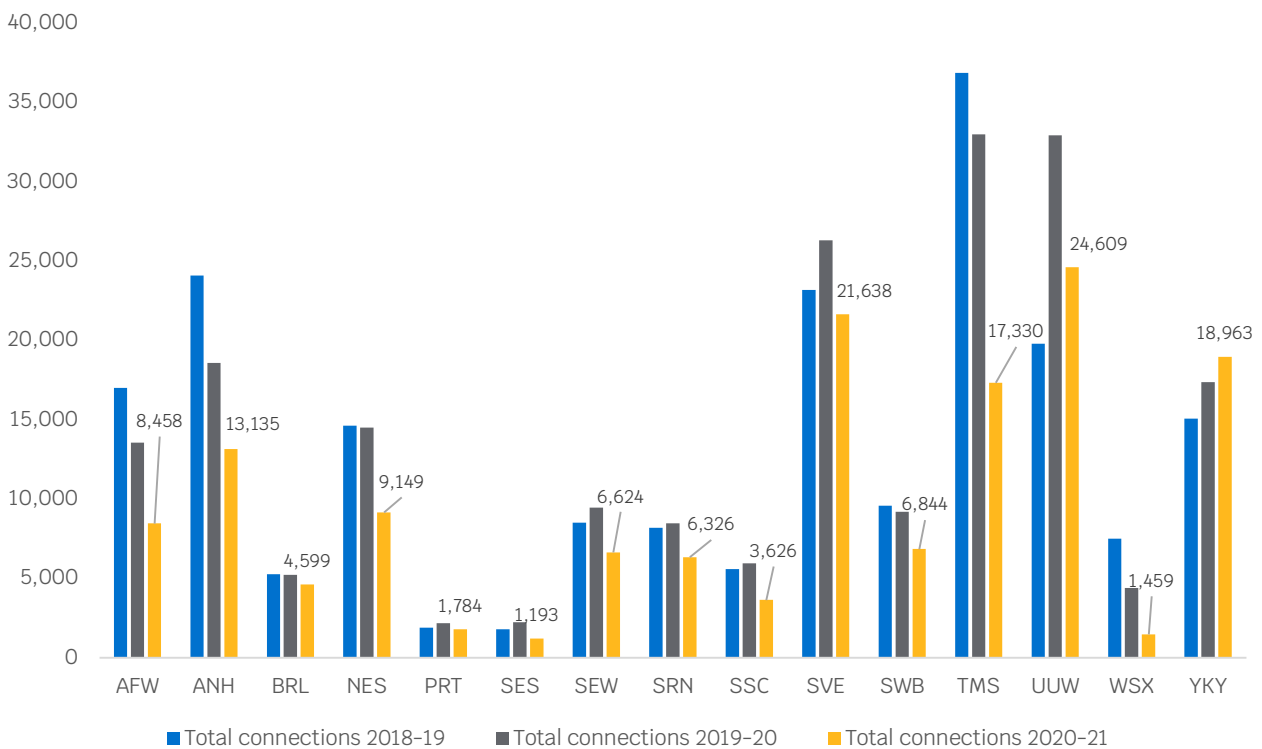
	1-10 properties	11-25 properties	26-40 properties	41-60 properties	61+ properties
Affinity Water (AFW)	24%	26%	0%	44%	41%
Anglian Water (ANH)	34%	48%	65%	58%	74%
Bristol Water (BRL)	44%	58%	81%	73%	75%
Hafren Dyfrdwy (HDD)	n/a	n/a	n/a	n/a	n/a
Northumbrian Water (NES)	25%	25%	21%	20%	9%
Portsmouth Water (PRT)	0%	0%	0%	0%	0%
SES Water (SES)	0%	n/a	n/a	n/a	n/a
South East Water (SEW)	n/a	n/a	n/a	n/a	n/a
South Staffs Water (SSC)	10%	29%	100%	100%	100%
Severn Trent Water (SVE)	15%	39%	65%	100%	79%
South West Water (SWB)	0%	0%	0%	0%	0%
Thames Water (TMS)	16%	40%	49%	33%	9%
United Utilities (UUW)	48%	79%	80%	92%	96%
Dŵr Cymru (WSH)	0%	30%	0%	21%	35%
Wessex Water (WSX)	11%	17%	34%	32%	n/a
Yorkshire Water (YKY)	15%	23%	28%	16%	46%

Source: Ofwat analysis of granular 2020–21 developer services data (financially closed new developments that required new requisition mains).

Non-price factors may cause differences in self lay provider activity

- Differences in relationship quality between incumbents and self lay providers could contribute to regional differences in self lay provider activity (as discussed above).
- Differences in regional demand for developer services, and the location of self lay provider bases may also drive differences in self lay provider activity (Portsmouth Water has two self lay providers whereas Yorkshire Water has 51 self lay providers).
- It may therefore not be feasible for incumbents to have the same level of self lay provider activity.

Figure 3.5: new connections 2018-19 to 2020-21 by company



Source: SIA Partners. '[Connection Charges for Developer Services in England. Root Cause Analysis](#)'. August 2021.

Table 3.3: Number of self lay providers and new appointees operating in each incumbent water company's area

	AFW	ANH	BRL	HDD	NES	PRT	SES	SEW	SRN	SSC	SVE	SWB	TMS	UUW	WSH	WSX	YKY
Number of active self lay providers	20	19	8	5	20	2	7	19	11	15	36	8	34	37	14	8	51
Number of active new appointees	1	5	2	0	4	1	1	0	3	1	3	2	7	3	0	3	2

Source: Ofwat analysis of granular 2020-21 developer services data.

Inclusion of developer services in the single till may not play a key role in determining how incumbents set developer services charges

- SIA Partners found there is wide regional variation in the level of connection charges for the same hypothetical development. For example, typical charges for a 50-house development ranges from £39,216 to £147,590.²¹
- SIA Partners found no single cause for this variation. Factors identified included: methodology for generating charges; delivery models; economies of scale; and overheads.²² But the inclusion of developer services in the single till was not identified as a factor driving differences in developer charges.
- This supports our understanding that companies set developer charges independently of the price control settlement. This may limit the role the inclusion of developer services in the single till has on developer charges.

²¹ SIA Partners, '[Connection Charges for Developer Services in England. Root Cause Analysis](#)', Table 1 – Summary statistics of costs and charges for the four scenarios, page 9.

²² SIA Partners, '[Connection Charges for Developer Services in England. Root Cause Analysis](#)', pages 2 to 3.

4. Proposed approach to regulating network reinforcement at PR24

Network reinforcement is almost entirely delivered by the incumbent water companies. So, we do not consider the removal of price control regulation would sufficiently protect the interests of developer services customers from the incumbents potentially taking advantage of their monopoly position (eg higher network reinforcement prices).

We considered two broad options for the regulation of network reinforcement at PR24:

- 1) **Remain in the network plus price controls**; or
- 2) **A separate developer services price control**, which includes network reinforcement and site-specific developer services

We propose that network reinforcement remains in the network plus price controls at PR24 (Option 1) for the following reasons:

The substantial temporal mismatch between costs and revenue for network reinforcement work would make a separate developer services control difficult.

The creation of a standalone developer services price control (Option 2) may create a perceived cash flow problem if the incumbent water companies undertake network reinforcement activity and incur costs before work begins on the development site and companies subsequently receive revenue from developers. This may lead to incumbents being hesitant in starting network reinforcement early and subsequently reduce the timeliness of new connections.

This is not a problem under Option 1 because incumbents can recover the costs incurred from water bill payers in the short term before returning the money to customers once the developer has been charged for the work.

The substantial interactions with other water company activities (eg capital maintenance) do not facilitate accurate cost separation required for a separate developer services control

Under Option 1 we can assess network reinforcement with other costs (eg capital maintenance) if needed. We applied this approach at PR19 by assessing network reinforcement with base costs.

But Option 2 relies on network reinforcement costs and revenue being separated from other activities, which is not straightforward. For example, there are synergies with asset replacement. When network assets reach the end of their useful life companies can replace them with either like-for-like assets or assets that deliver greater capacity with only a

fraction of additional cost. This leads to costs being proportionality allocated between network reinforcement and capital maintenance.

A separate developer services price control would be challenging to implement

A separate developer services price control may allow a more targeted approach to developer services regulation. But it would be challenging to implement effectively because:

- There would be greater emphasis on accurate developer services cost assessment than under the current regulatory approach. For example, the option to assess network reinforcement costs with base costs would not be available.
- We would need to decide on the appropriate form of control. For example, a total revenue cap or price cap(s).
- We would need to determine an appropriate return on developer services activities (if any), which is not required if network reinforcement remains in the network plus control.
- We would need to work out how to deal with cost over or under recovery. Under the current regulatory approach, any cost over- or under-recovery is offset by changes in water customer bills. But this is unlikely to be possible in a separate developer services control. Finding an appropriate way to do this would be particularly important because of the mismatch between network reinforcement costs and revenue discussed above.

4.1 Network reinforcement cost assessment

At PR19, we included network reinforcement costs in our wholesale base cost models. We used this approach because network reinforcement shares similar characteristics to base costs (eg companies experience these costs on a year-on-year basis) and cost drivers (eg company size and population density).

This approach also helped to mitigate for synergies and reporting inconsistencies between network reinforcement and base costs. For example, when network assets reach the end of their useful life, water companies can replace them with assets that deliver additional capacity. Three companies also reported zero network reinforcement expenditure between 2011-12 and 2016-17, as shown in the tables below.

In response to our 'Assessing base costs at PR24' consultation,²³ stakeholders including water companies suggested assessing network reinforcement costs separately from base costs at PR24. We are open to considering this at PR24 if the issues identified above can be addressed. We have recently issued a network reinforcement data request²⁴ to collect additional cost driver information to support our assessment at PR24. More details are provided in appendix 9.

²³ Ofwat, '[Assessing base costs at PR24](#)', December 2021

²⁴ Ofwat, '[Network reinforcement data request](#)', May 2022

Table 4.1: Wholesale water network reinforcement expenditure reported by incumbent water companies between 2011-12 and 2020-21, £m 2017-18 (capital expenditure only up to 2019-20; total expenditure in 2020-21)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Affinity Water	12.6	8.5	7.9	8.0	13.1	5.6	2.7	5.1	4.8	6.8
Anglian Water	10.9	21.8	25.0	32.4	6.8	13.7	11.6	19.7	25.9	17.0
Bristol Water	3.3	5.1	4.6	3.0	1.7	3.1	5.1	0.9	1.1	2.4
Northumbrian Water	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.6	2.0	0.3
Portsmouth Water	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.3	0.7
SES Water	1.0	0.5	0.9	0.7	1.1	0.9	1.3	2.6	1.1	0.1
South East Water	16.2	13.7	9.1	12.9	22.4	11.6	5.5	4.0	3.4	4.4
South Staffs Water	0.9	0.6	0.2	0.5	0.4	0.3	1.0	1.4	0.8	0.8
Severn Trent Water ²⁵	32.0	27.7	26.4	37.4	40.6	37.7	8.1	6.6	10.2	6.4
South West Water ²⁶	2.3	0.2	0.1	0.9	0.4	0.2	1.0	0.3	0.1	0.1
Southern Water	1.7	0.2	0.1	0.0	0.0	0.0	0.3	0.3	0.2	0.3
Thames Water	5.6	7.1	25.8	20.5	2.5	7.4	8.2	0.2	5.9	10.6
United Utilities	5.8	6.4	6.1	6.4	6.9	4.9	1.4	6.1	8.4	2.3
Dŵr Cymru	0.6	6.2	2.9	0.1	0.1	0.5	0.5	0.9	0.2	0.3
Wessex Water	3.9	3.0	2.7	4.8	7.6	7.6	0.2	0.4	0.8	0.9
Yorkshire Water	0.0	0.0	0.0	0.0	0.0	0.0	2.4	1.6	4.3	4.0

Source: Analysis of company submissions to Ofwat.

Table 4.2: Wholesale water network reinforcement expenditure reported by incumbent water companies between 2011-12 and 2020-21, £m 2017-18 (capital expenditure only up to 2019-20; total expenditure in 2020-21)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Anglian Water	2.8	9.3	12.7	13.7	12.3	19.8	25.0	6.4	14.7	11.1
Northumbrian Water	0.0	0.0	0.0	0.0	0.0	0.0	0.6	0.4	0.1	5.5
Severn Trent Water ²⁷	3.1	3.0	3.0	0.8	4.7	3.2	2.6	7.9	5.7	3.5
South West Water ²⁸	4.7	3.8	5.0	5.8	12.2	7.0	3.0	4.6	3.2	4.1
Southern Water	1.6	2.8	7.4	5.0	2.3	2.9	2.0	3.9	4.2	0.0
Thames Water	0.5	1.6	14.5	4.6	0.7	0.6	15.0	8.9	10.9	10.4
United Utilities	3.5	8.6	12.3	17.6	8.6	14.2	7.3	6.0	6.4	13.6
Dŵr Cymru	6.6	8.2	9.5	6.3	5.0	4.3	3.0	1.6	2.1	1.6
Wessex Water	1.9	1.9	6.0	6.2	2.8	5.7	2.1	5.0	4.4	3.5
Yorkshire Water	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6	2.7	1.8

Source: Analysis of company submissions to Ofwat.

²⁵ Including Dee Valley up to and including 2017-18 and Hafren Dyfrdwy from 2018-19.

²⁶ Including Bournemouth Water.

²⁷ Including Dee Valley up to and including 2017-18 and Hafren Dyfrdwy from 2018-19.

²⁸ Including Bournemouth Water.

4.2 Network reinforcement reconciliation mechanism

We are interested in stakeholder views on whether an ex-post reconciliation mechanism is required to account for differences between actual and forecast network reinforcement work delivered, given our preferred option to regulating network reinforcement at PR24 is for it to remain in network plus price controls.

The PR19 DSRA included network reinforcement. But network reinforcement is not site-specific and can often be planned ahead of work starting on the development site based on forecast growth / new developments in a company's operating area. There should therefore be a higher degree of certainty on network reinforcement requirements in the next 5 years than site-specific developer services.

For these reasons, we consider that the inclusion of network reinforcement in cost sharing would be enough to manage uncertainty around the volume and mix of network reinforcement work to be delivered. This would avoid the need for a separate network reinforcement reconciliation mechanism, or inclusion of network reinforcement in a revenue reconciliation mechanism created for site specific developer services costs.

5. Proposed approach to regulating wastewater site-specific developer services

We considered two broad options for the regulation of wastewater site-specific developer services at PR24, informed by our review of developer services regulation at PR19 (Section 2) and state of competition in developer services review (Section 3):

- 1) **Improved status quo** – wastewater site-specific developer services remain in the network-plus price control. We would consider making improvements to the PR19 approach where possible (eg cost assessment; reconciliations); or
- 2) **Remove wastewater site-specific developer services from the price control**

Option 2 is our preferred option for wastewater site-specific developer services.

We propose that wastewater site-specific developer services are excluded from the wastewater network plus price control. This is feasible because costs and revenues for wastewater site-specific developers can be separated from other activities given recent improvements to reporting and more limited interactions with other company activities compared with network reinforcement.

Nearly all wastewater site-specific developer services are delivered by developers and self lay providers (98%), so water companies have little overall market power. Total allowed wastewater site-specific developer services revenue was £162 million at PR19, or 0.6% of allowed wastewater network plus revenue. This is substantially lower than allowed water site-specific developer services revenue at PR19 (£1.1 billion or 4.8% of allowed water network plus revenue).

We consider our proposed approach is proportionate and targeted given the current state of competition for wastewater site specific developer services. It will substantially reduce regulatory complexity and burden compared to Option 1 (eg no challenging cost assessment or reconciliations), whilst meeting developer services customers' needs and interests.

It will also support the continued development of the market for wastewater site-specific developer services by removing potential market distortions caused by the inclusion in the price control (eg inappropriate cost allocation leading to potential cost cross-subsidisation with other wastewater company activities). Incumbent wastewater companies will be able to recover efficient costs associated with the services they deliver providing they set cost reflective charges, and they will face similar risks to other market participants (eg market share risk; unexpected cost increases; etc.).

Incumbent wastewater companies will continue to be incentivised to provide good service to developers, self lay providers and new appointees through competition, D-MeX and the Code

for Adoption Agreements. And unexpected changes in wastewater site specific developer services revenue will no longer lead to year-on-year changes in water customer bills, improving water bill predictability.

We consider that wastewater site-specific developer services customers will be sufficiently protected by competition and charging rules. We will consider whether any changes to charging rules are needed to protect customers in the small number of cases where only the incumbent wastewater company can provide wastewater site-specific developer services ahead of our final methodology. For example, on sites with access issues, such as the need to cross a railway, where the incumbent needs to use its statutory powers.

6. Proposed approach to regulating water site-specific developer services at PR24

We have created a menu of options for regulating water site-specific developer services at PR24, to address the issues with the current regulatory regime (Section 2) and reflect the state of competition in water site-specific developer services (Section 3).

These options look at the extent to which water site specific developer services remain in the price control and the degree to which additional regulatory protections are provided.

Inside wholesale water network plus price control

Option 1: improved status quo

Site-specific developer services remain in the network-plus price control. We would consider making improvements to the PR19 approach where possible (eg cost assessment; reconciliations).

Partly inside wholesale water network plus price control

Option 2: remove competitive market segments from the price control; other market segments remain in the price control

Developments with more than 25 properties are excluded from the price control. We would introduce transitional arrangements for companies with low levels of third-party activity in this market segment. For example, only allowing these companies to increase developer charges in line with the consumer prices index including housing costs (CPIH) for developments with more than 25 properties.

Developments with 25 properties and less remain in the price control and would be regulated as in Option 1 (ex-ante cost assessment; revenue reconciliation mechanisms; etc.).

Outside of wholesale water network plus price control

Option 3: separate developer services price control

Wholesale water site-specific developer services would be removed from the wholesale water network plus price control. But they would remain regulated through a separate binding price control for developer services. The price control would include site-specific developer services (and potentially network reinforcement).

Option 4: remove all market segments from the price control; backstop regulation for market segments with limited competition

Water site-specific developer services are excluded from the network plus price control.

Review costs at the price review and monitor costs and revenue annually through the annual performance report (APR). Cost recovery risk borne by companies.

For new developments with more than 25 properties, we would consider introducing transitional arrangements for companies with low levels of third-party activity in this market segment. For example, only allowing developer charges to increase in line with CPIH.

For new developments with 25 properties and less, we would introduce backstop regulation so that developer services customers are sufficiently protected in potential instances of market power. This could include:

- only allowing companies to increase developer charges in line with CPIH; and/or
- returning any cost over-recovery to customers at the PR24 end-of-period reconciliation to ensure incumbent water companies do not benefit financially from overcharging developer services customers.

6.1 Option assessment framework

Our option assessment framework is presented below and builds on the framework developed by CEPA.²⁹ It is informed by our analysis of issues with developer services regulation at PR19 (Section 2) and our review of competition in developer services (Section 3).

The framework is consistent with:

- the general statutory duties for most of our work set out in [section 2](#) of the Water Industry Act 1991 (WIA91);³⁰
- the principles of best regulatory practice (including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed)³¹;
- the UK government's strategic policy statement (SPS)³² which expects Ofwat to:
 - promote greater collaboration between incumbents and their developer services customers, particularly on large-scale developments;
 - improve fairness and transparency in incumbents' charging arrangements and further promote sustainability and environmental protections;

²⁹ CEPA. [Approach to the regulation of developer services at PR24](#). May 2021.

³⁰ UK government, '[Water Industry Act 1991](#)', section 2.

³¹ We are required to have regard to these principles in carrying out most of our work (including setting price controls) by section 2(4) of the WIA91.

³² UK government, '[The government's strategic priorities for Ofwat](#)', updated 28 March 2022.

- consider how our regulatory framework can enable water and wastewater services to support government's ambitions to increase housing supply, in line with our duty to contribute to the achievement of sustainable development;
- the Welsh Government's strategic priorities, which expect Ofwat to keep under review our approach to developer services to ensure it is fit for purpose to support economic development in Wales; and
- our PR24 ambitions - focusing on the long term; delivering greater environmental and social value; reflecting a clearer understanding of customers and communities; and driving improvements through efficiency and innovation.

We set out our assessment of the options against these criteria in Section 6.2 below.

Figure 6.1: developer services regulation option assessment framework

(1) Meet customers' needs and interests

- Meet all customers' needs given the current status of competition in developer services, including developers / new customers, self lay providers and new appointees. This includes protecting developer services customers from potential monopoly pricing and poor service quality when competition is limited.
- Support the UK government's ambitions to increase housing supply, and meet the Welsh Government's expectation for us to keep under review our approach to developer services to ensure it is fit for purpose to support economic development in Wales.
- 'Fairness' of developer services cost recovery between new and existing customers, and the wider impacts of developer services on the environment.
- Facilitate predictable, transparent and stable developer charges and water bills.

(2) Facilitate effective competition

- Promote a level playing field, so that efficient market entry is possible from self lay providers and new appointees within developer services markets. This will drive improvements through efficiency and innovation.
- Incumbents must be incentivised or obliged to provide a good quality of service to self lay providers and new appointees (ie act as market facilitators).

(3) Effective incumbent regulation

- Facilitate efficient cost recovery.
- Ensure no cost cross-subsidation with other water company activities.
- Provide clear and appropriate incentives.
- Be flexible to different market conditions across England and Wales.
- Appropriate balance of risk and reward.
- Support water and sewerage undertakers in properly carrying out their statutory functions and the resilience objective.

(4) Regulation complexity

- The regulatory approach should be proportionate, targeted, transparent and with a low risk of unintended consequences.

(5) Regulation burden

- Ease of implementation and operation.

6.2 Option assessment

It is more feasible to exclude site-specific developer services from the water network plus price control, compared to network reinforcement. There are more limited interactions with other company activities, and potential mismatch between costs and revenue is also more limited, which avoids potential cash flow problems. Recent improvements in cost and revenue reporting are also helpful.

But the options are more finely balanced than for wastewater site-specific developer services because the incumbent water company remains the dominant service provider in certain regions of England and Wales and for certain new development types. We therefore do not consider it appropriate to exclude water site-specific developer services from the price control without introducing alternative regulatory protections for market segments that currently have low levels of competition.

Section 2 showed that self lay providers work on a similar number of new developments as incumbents when the size of the development surpasses 25 properties. But self lay provider activity remains low in small developments (25 properties and under), with incumbent water companies being the dominant service provider. Developments of 25 properties and less accounted for 47% of new connected properties in 2020–21. It is important that our regulatory approach sufficiently protects customers that have limited choice in the market.

We therefore propose to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24. We will introduce transitional arrangements for companies with low levels of third-party activity in this market segment. For example, only allowing these companies to increase developer charges in line with CPIH for developments with more than 25 properties. This is consistent with the transitional arrangements discussed in Options 2 and 4 above. If we proceed with this proposal, we will consult separately on what transitional arrangement there should be.

We propose that new developments of 25 properties and below should either:

- **remain in the wholesale water network plus control** (Option 2); or
- **be removed from the wholesale water network plus control but with alternative protections to protect water site specific developer services customers** in this market segment from potential monopoly power (Option 4).

We are interested in stakeholder views on the relative merits of each of these options, and how we could achieve suitable customer protection under Option 4 (eg through changes to our charging rules or applying an ex-post reconciliation mechanism).

We are therefore proposing either Option 2 or 4. The choice between these options is finely balanced.

Options 2 and 4 would both:

- continue to protect customers who do not currently have much choice in the market (either through price control regulation or backstop regulation);
- present a clear path towards more proportionate and targeted regulation and reward companies that have actively sought to increase competition;
- encourage companies to facilitate the market going forward because those who do not qualify for de-regulation in PR24 may qualify in PR29; and
- facilitate efficient cost recovery and be flexible to different market conditions across England and Wales.

Option 2 allows us to benchmark costs between companies and apply an ex-ante cost efficiency challenge to market segments with limited competition. This is not possible in Option 4 as it relies on backstop regulation (eg restricting year-on-year increases in developer charges), which may lead to inefficiencies.

However, Option 4 is less complex and burdensome because the need for challenging cost assessment and reconciliation mechanisms is removed. This should provide clearer incentives to incumbent water companies.

Option 4 is also conceptually closer to how self lay providers operate (ie pricing up work on a case by case basis). And will support the continued development of the market for water site-specific developer services by removing potential market distortions caused by the inclusion in the price control (eg potential cost cross subsidisation with other company activities that could risk developer charges being set too low). This may better facilitate a level playing field between incumbent water companies, self lay providers and new appointees, facilitating more competition and supporting new development.

Finally, unexpected year-on-year changes in water site specific developer services revenue would no longer require changes in water customer bills under Option 4, improving water bill predictability.

Under both Option 2 and Option 4 there is a risk that incumbent water companies are encouraged to do more work themselves where they can be financially rewarded for doing so, rather than facilitate the market. This risk should be mitigated by the threat of greater regulation and monitoring at future price reviews, D-MeX and the Code for Adoption Agreements.

We reject Option 1 (improved status quo) as it would maintain a complex system of regulation that could distort the market. There is evidence of growing competition that we currently see in developments with more than 25 properties. The inclusion in the network plus price control risks cost allocation issues that could lead to cost cross subsidisation with other activities. This could lead to companies setting developer charges too low. Similarly, inclusion in the network plus price control protects water companies from market share risk

because lost revenue can be recovered through water customer bills if work is completed by other providers, or their developer charges are set too low. This may prevent third parties from entering the market, and/or discourage incumbent water companies from competing with third parties. Both eventualities could reduce the benefits of competition (eg greater choice, efficiency, innovation, better service quality). Option 1 also does not offer a clear route to more proportionate and targeted regulation.

A separate developer services price control (Option 3) may allow a more targeted approach to developer services regulation and offer a clearer route towards lighter touch developer services regulation compared to Option 1. It would also remove water bill volatility caused by the inclusion of developer services in the network plus price control. It is more feasible than for network reinforcement because of the limited interactions with other activities and limited mismatch between costs and revenue (assuming the control focuses on site specific developer services). But **we reject Option 3** because of the additional challenges it would bring, as set out in Section 4, which we think would be disproportionate and outweigh the potential benefits.

7. Other developer services issues

English water companies

We also regulate developer services through our charging rules for English water and wastewater companies. We have made several important changes to the way English water companies charge for developer services since 2018. Our changes have supported the connections market by improving the way companies set out their charges and making them more cost reflective. This has allowed self lay providers and new appointees to compete on level terms with incumbent water companies, and has given developers and third parties greater opportunity to exercise their choices.

An important change to the way we regulate developer services is our October 2021 decision to remove from English water companies the ability to offer income offset and to remove the balance of charges rule from April 2025.³³ In this way, we aim to encourage:

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

In our October 2021 decision we said that we would give further consideration as to how to implement these changes, considering the balance between issues such as bill stability and regulatory complexity.

One option would be to formally introduce transitional arrangements so that companies with high levels of income offset phase out their removal. We have decided not to adopt such an approach. This would unnecessarily increase regulatory complexity, noting that companies are required by the charging rules to reflect the principles of stability and predictability (amongst others). In practice, we are pleased to see that some water companies are already preparing for the change, which is still more than two years away. We expect companies to effectively communicate their plans in good time to enable developer customers, self lay providers and new appointees to prepare for any changes.

Removing contributions from household customers via the income offset reduces household bills and improves affordability. Currently, discounts through income offsets represent a substantial cross-subsidy from general customers to developers, approximately £670million over the current price control period, which is about £6 per household property per year on average, within a range of zero to c.£10 per household property a year.

³³ See [Scope and balance of developer charges and incentives – conclusions – Ofwat](#), October 2021.

But we want water companies to do more to incentivise water efficiency and sustainable drainage, and one way they can do this is by offering environmental discounts for sustainable developments (or surcharges for developments that do not promote water/waste efficiency).

Any discount or surcharge included in charges for developer services reflecting environmental or social issues should have a clear rationale and should not be funded by general customers. Instead, any discount will be funded by other developer services customers (so they are revenue-neutral within developer services). This is consistent with our reforms to make charges more cost reflective and remove cross-subsidies between different types of customers. It is also aligned with our proposed approach to developer services in PR24, discussed above. We welcome stakeholder views on our proposed approach to environmental discounts for sustainable developments, and will engage further with them on this issue in due course.

We are also consulting on our approach to nutrient neutrality at PR24. Natural England requires developments located in certain catchments, where freshwater habitats and estuaries experience nutrient pollution, to be nutrient neutral. Such developments may experience delays in the planning process and / or costs of mitigating associated nutrients. We discuss this in more detail in Appendix 9.

Welsh water companies

The Water Act 2014 included changes to the WIA91 that allows us to set charging rules for new connections services in England and Wales. In December 2017, the Welsh Government issued us with charging guidance which included guidance on setting these rules. We have consulted on draft rules.³⁴ However, the Welsh Government would need to bring into force the relevant provisions in the Water Act 2014 before charging rules for new connection services can be applied to Welsh water companies, and we are awaiting confirmation from the Welsh Government on its approach.

The policy proposals and options that we set out in this appendix assume that we will establish new connection charging rules for Welsh companies on or prior to April 2025. If we do not, then we will need to consider whether we can remove water and/or wastewater site-specific developer services from the price control for Welsh water companies, particularly if the income offset remains.

³⁴ Ofwat, '[Consultation on new connections charging rules for Welsh companies](#)', February 2021.

8. Consultation questions

Our consultation questions related to developer services are set out below, and are also included in Chapter 3 of our draft methodology:

Q1. Do you agree with our proposal to include network reinforcement in the network plus price controls at PR24?

Q2. Do you agree that the inclusion of network reinforcement in cost sharing would be enough to manage uncertainty around the volume and mix of network reinforcement work to be delivered?

Q3. Do you agree with our proposal to remove wastewater site-specific developer services from the wholesale wastewater network plus price control?

Q4. For water site-specific developer services:

a) Do you agree with our proposal to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24, but with transitional arrangements for companies with low levels of competition?

b) Do you think that new developments of 25 properties and below should remain in the wholesale water network plus control or be removed? If they were removed from the price control, what alternative protections could we introduce to protect developer services customers from potential monopoly power?

Q5. Do you have any views on any other aspect of our developer services proposals in this appendix?

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

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