



Driscoll 2
Ellen Street
Cardiff, CF10 4BP
Telephone: 02920 028 711
Website: iwnl.co.uk

PR24 draft methodology consultation response
Ofwat
Centre City Tower
7 Hill Street
Birmingham, B5 4UA

Email: PR24@Ofwat.gov.uk

7 September 2022

Dear Ofwat,

Response to: Consulting on our methodology for PR24

I am writing to you on behalf of independent Water Networks Limited (“IWNL”), part of the BUUK Infrastructure Group of companies, in response to the Ofwat consultation on its [methodology for PR24](#) which was published in July 2022. Appendix 1 contains our responses to the consultation questions that were particularly relevant to IWNL. I can confirm that this response is not confidential.

Summary of IWNL views on Ofwat’s draft methodology for PR24

We welcome the publication of Ofwat’s consultation on its Methodology for PR24 and the continued commitment it demonstrates on Ofwat’s behalf to maintaining an open and collaborative approach to the development of the upcoming price control arrangements. We recognise, and largely agree with, the three industry challenges that Ofwat presents in the consultation but think it is critical that the reference to a ‘neat and discrete’ set of issues does not underplay the scale of these challenges or overlook the many and varied concerns that need to be addressed during PR24.

While we are supportive of the continued use of Ofwat’s building block approach, we note the inherent difficulties associated with appropriately setting the key parameters of each of the components of this framework in a market that is extensively regulated. We think the introduction of greater competition could remove the need to explicitly define each of these parameters by instead allowing them to be determined via the natural interplay of market forces. At the same time, the different perspectives that new entrants would bring to the sector, could unlock some of the key challenges that incumbents are struggling to effectively overcome. We therefore think Ofwat should prioritise work to open up markets, where possible, as a key component of each of the building blocks and associated toolkit.

We agree with Ofwat's proposal to keep network reinforcement in the price control but think it is too early to remove site-specific developer services from PR24 as the necessary preconditions that should be evident have not yet been demonstrated. As such, Ofwat has not adequately proven: that incumbents deliver consistent, high levels of service; that reasonable NAV margins are available; that regulatory barriers inhibiting a level-playing-field have been removed; or that competition is sufficient to protect customers. We also have concerns about the assumptions used by Ofwat in its assessment and do not think the regulator has demonstrated that competition will provide required customer protection. We therefore think developer services should be retained within the price control until it is possible to demonstrate that competition is fully developed; removing these services prematurely could have a significant impact on the future development of the market.

We very much welcomed the introduction of D-MeX at PR19 and believe the mechanism has helped to improve incumbent performance. However, we do not agree with the Ofwat assertion that it is too early to consider potential changes to D-MeX on the basis that only one full year of reporting data is available. We expect the 2021-22 D-MeX results to be available imminently; meaning that any proposals would be based on two years of data. We also note that Ofwat only has one full year of reporting data available for any of the incentive mechanisms that were introduced at PR19, so it is unclear why this scheme is being singled out. If the mechanism was operating seamlessly Ofwat's stance may not cause significant concern, but we have identified issues which we think it will be important to address at PR24 to ensure that the D-MeX delivers in line with desired outcomes; these primarily relate to D-MeX targets, definitions and customer representation.

We note that government published a [Statement on nutrient pollution](#) in July in which it confirmed that it would: impose a duty on water companies to upgrade wastewater treatment works to the highest technical limits; and establish a nutrient mitigation scheme from which developers can purchase 'nutrient credits' which will fulfil their obligations toward nutrient mitigation. The Ofwat consultation included provisions for this, proposing that developers should contribute to the costs incurred to upgrade water treatment works. As such, developers would be expected to purchase nutrient mitigation scheme credits as well as contributing to water company costs and we think this approach will create an undue burden. We also note that the proposed approach is inconsistent with the position that Ofwat confirmed in its decision on the [Scope and balance of developer charges](#).

I hope that this letter is helpful; if you have any questions on any of the issues I have raised or would like to discuss these in more detail, please feel free to get in touch.

Yours Sincerely,

A large black rectangular redaction box covering the signature area.

Keith Hutton
Group Regulation Director, BUUK

Appendix 1: Responses to individual consultation questions

Questions in Chapter 2 – Regulating through the price review

Q2.1: Do you agree with the challenges facing the sector and the ambitions for PR24 we have identified?

In its consultation on the methodology for PR24, Ofwat asserts that the challenges facing the sector are clear and urgent; and fall within the following three areas:

- combatting climate change and protecting / enhancing the environment;
- rising customer expectations about what companies should deliver; and
- the need for affordable bills.

While we largely agree with the overarching categories that Ofwat has presented, we think it is critical that the reference to a discrete suite of issues does not underplay the scale of the challenge that the industry is currently facing. In this respect, we consider the challenges facing the industry to be many and varied: ranging from national / international issues associated with the transition to net zero, rises in the cost of living and the need to attract significant new investment in ageing infrastructure; to more industry-specific issues such as sewer flooding, leakage, per capita consumption, and customer engagement. While arguably all of these challenges fall within the three areas presented by Ofwat, and summarised above, it will be important that Ofwat remains cognisant of the particular issues that each individual challenge raises for incumbent water companies, when developing any future-focused policy including policies to support PR24.

Q2.2: Do you agree that continuing to use our three building blocks helps push companies to meet our ambitions for PR24?

The consultation recognises the potential role of markets in delivering good outcomes for customers, society and the environment at a reasonable cost, and refers to Ofwat's efforts to increase the role of markets in certain key areas e.g. DPC, bioresources and developer services. While we welcome the efforts that Ofwat has made in each of these areas, we think there is more work to be done to facilitate the further evolution of competition in each of these, and potentially other, areas of the water industry. We believe that competition could unlock some of the key challenges that incumbents are struggling to effectively overcome and therefore think that Ofwat should prioritise work to open up markets, where possible, as a key component of each of the building blocks and its associated toolkit.

A potential role for competition in supporting the PR24 building blocks

We anticipate that competition could help to facilitate effective delivery against each of the PR24 building blocks in the following ways.

- **Outcome delivery:** Experience demonstrates that new entrants to a sector are more likely to approach age-old issues from a new perspective and therefore find innovative ways of working that support the delivery of desired outcomes in a more economic

and efficient way. In addition, new entrants are inevitably subject to different market dynamics and will be incentivised to 'think outside the box' to secure new business.

- **Affordability:** It is universally accepted that, where competitive forces are exerted in a market this naturally creates pressure for prices to become more aligned to the marginal cost of production. These principles apply to the water and wastewater industries, and we believe that if markets are increasingly opened up to competition, where possible, this could help to relieve some of the pressures that customers are currently facing as a result of the cost-of-living crisis. This is particularly true given the scale of the challenge that many utilities, including water, are currently facing and the anticipated volume of investment that will be needed to overcome these issues.
- **Aligning risk and return:** The size of the WACC is one of the most hotly anticipated elements of any price control, and often one of the most contentious. While utilities are traditionally low risk and the WACC tends to reflect this, incumbents will increasingly need to take more risky decisions (given the challenges that the industry is facing) and this could arguably place upward pressure on the WACC. By increasingly opening up markets, and effectively introducing competition where it is possible to do so, relevant industry segments could be removed from the price control, allowing natural market forces to operate in these areas and determine an appropriate return.
- **Long-term delivery:** Since inception of the RPI-X mechanism in the early 1980s, it has commonly been acknowledged that the length of the price control has a direct impact on the timing of company investment decisions. In this respect, the investment horizon of regulated companies tends to become aligned to the length of the price control, creating a relatively short-termist view. The RIIO framework in energy sought to overcome this, and establish long-term delivery incentives, by increasing the length of each price control period; but this inevitably led to constraints on the investment horizon that were aligned to the slightly increased timeframes. Significant further effort has been expended to develop more subtle incentives to overcome the tendency toward short-termism. We think a simple solution could be to increasingly open up markets, and effectively introduce competition where possible, which would allow the relevant industry segments to be taken out of the price control and remove any arbitrary time constraints from company investment decisions.
- **Encouraging high-quality and ambitious business plans:** A big challenge that regulators have historically faced in determining price control settlements stems from the information asymmetry that regulated monopolies inevitably benefit from. Over time we have seen an increase in the volume of information that is provided during price control reviews, and an associated increase in the level of analysis carried out. However, despite their best efforts, we doubt that it will ever be possible for regulators to overcome the problems presented by information asymmetry. If regulators were to overhaul their traditional approach and seek to open up markets to allow alternative modes of outcome delivery / associated costs to be considered, incumbents would become increasingly aware of the potential implications for future revenue streams, and ultimately the RAB. We anticipate that the resulting incentive structure is likely to encourage incumbents to be more ambitious.

In addition to facilitating effective delivery against each of the stated building blocks of the PR24 price control, we anticipate that increasing levels of competition in various 'pockets' across the water industry would help to facilitate natural levels of innovation in the sector. While we recognise the drivers and value of Ofwat's innovation fund, we think the challenge of affordability in a sector that will require significant investment in the coming years, will mean that this fund is unsustainable over the longer term.

Real-world examples of the potential benefits of competition

We think there is benefit in considering these arguments not just in the abstract but also by referencing real-world examples. There are clear cases where the development of effective competition and increasing removal of barriers to a level playing field have demonstrated the potential to deliver substantial benefits; not only for the water sector but also in terms of facilitating wider government targets.

We note the ongoing political discussions around effective delivery of the 'levelling up' agenda and a key component of this is the expeditious construction of new build houses at an efficient cost. We believe that competition in the delivery of new connections could play an important role in effectively facilitating this outcome. In this respect, in its recent [Competition Stocktake report](#), published in July 2022, Ofwat recognised that "it is possible that the competitive pressure caused by NAVs providing better service at lower cost could lead to broader benefits for end customers of incumbent companies". Ofwat also stated that "Many developers tell us that new appointees install assets...around 25-50% quicker than incumbent companies". Given the benefits that NAVs can deliver in terms of reducing costs / improving timeframes, we think further development of competition in this market could significantly improve the scope to effectively deliver the 'levelling up' agenda.

We very much welcome all the work that Ofwat has been doing to level the playing field for NAVs, via the improvements that were made to the NAV licensing process in 2019 and the ongoing efforts to progress discussions at the bulk supply working group (BSWG). However, we note that significant barriers still need to be overcome in order to allow NAVs to compete on the same basis as incumbent water and wastewater companies. Despite the improvements that Ofwat has made to its NAV licensing process and the progress that has been achieved via the BSWG, the arrangements that remain in place mean that we are still at a significant disadvantage, as compared with incumbents, when it comes to competing for new contracts.

- **NAV licensing:** The NAV licensing process, although reduced, is still subject to an Ofwat SLA of 119 calendar days, which equates to around four months. The SLA is a target rather than a guaranteed delivery timeframe and, where licence applications require further exploration, the process can take significantly longer. We welcome the efforts that Ofwat has taken to improve the process and the timeframes, particularly given the increase in the volume of applications that they have received in more recent years. However, given projections of likely NAV market growth, and the corresponding exponential increase in licence applications that this will necessitate, we do not think that the current approach will be sustainable.

We acknowledge the constraints that currently exist within the Water Act 1991 but think there is some flexibility to amend the existing process while still complying with the provisions of the Water Act. We very much welcome the recognition in Ofwat's Competition Stocktake report that "The current process...could arguably be seen as disproportionate in cases where the economic impact of a new application is very modest". Given the increasing growth of NAV businesses and the financial position that we now hold, many of the applications that we make would fall into this category and therefore do not require an extensive process of assessment prior to approval. We also welcome Ofwat's request for "Government to work with Ofwat in exploring... ways to update the regulation of the NAV market...to harness future opportunities to extend the...benefits of the market"; and look forward to working with you on this.

- **Bulk supply tariffs:** Despite the efforts that have been made by the BSWG over the past few years to bring transparency and consistency to the approach that incumbents take to the development of their NAV tariffs, it is clear that the charging arrangements are still not cost reflective. In this respect, the NAV charges that we face do not fully recognise the avoided costs that incumbents benefit from where a NAV serves a site. Despite extensive discussions at the BSWG, and the agreement of four working papers presenting revisions to the current approach, limited progress has been made to implement changes in the 2022-23 charging year; these delays have material commercial implications for our business and therefore inhibit the effective development of competition.

We note that Ofwat recently published the working papers that were agreed by the BSWG at the end of 2021, and that it intends to cross reference these as part of its Autumn 2022 charging notice. We welcome these developments and are optimistic that this could lead to a significant shift in, not only the tariffs that incumbents include in their 2023-24 charging arrangements but also, the levels of transparency that they provide. However, we are disappointed that Ofwat has not been more proactive in publishing these working papers and setting an expectation of incumbent compliance with their provisions. We believe that there would have been significant benefits for the competitive market if this transparency had been provided at an earlier point as it would have allowed NAV / incumbent discussions around cost reflectivity to take place well in advance of the 2023-24 charging year.

If these, and other remaining, barriers to the development of a level playing field for NAVs can be addressed, it will allow us to play a full role in effectively facilitating the 'levelling up' agenda. Over time, as effective competition develops, this would create a clear case for removal of the developer services market from the price control; helping to facilitate the benefits outlined above with respect to each of the building block components. However, given that it is still not possible for NAVs to compete on the same basis as incumbents and that the market remains significantly skewed in their favour, we do not consider that now is the appropriate time to remove this segment of the market from the price control. These issues are discussed in more detail in our response to questions 3.2 to 3.4 below.

Our expectation is that over time a level playing field for NAVs will emerge, similarly to the evolution of the independent connections market in gas and electricity; and we are hopeful that this will be observed over the course of PR24. We anticipate that NAV market benefits will be enhanced over time as the disadvantages that NAVs currently face in the competitive environment are increasingly eroded. This will have a knock-on effect in terms of associated benefits for market innovation, customer service, prices, and connections timeframes. We hope that positive outcomes from the development of competition in the market for new connections will give Ofwat the drive and confidence to consider opening up other areas of the market where possible. If more market segments can be liberalised, and effectively removed from monopoly control, this will help to overcome the traditional challenges associated with each of the building block components, outlined above.

Q2:3: Do you agree that we have struck the right balance between what's in and what's outside of the price control?

Please see our response to question 2.2 above and questions 3.2 to 3.4 below.

Questions in Chapter 3 – Design and implementation of price controls

Q3.2. Do you agree with our proposals to:

- a) Continue to include network reinforcement in the network plus price controls?**
- b) Remove wastewater site-specific developer services from the wholesale wastewater network plus price control?**

We agree with Ofwat's proposal to keep network reinforcement within the price control recognising that investment in required assets needed to deliver necessary reinforcement is almost entirely delivered by incumbents, and that competition is therefore insufficient to protect new connection customers. However, we believe it is too early to remove site-specific developer services from the price control at PR24 as we do not think necessary preconditions, that would need to be observed for this to happen, have been met.

The case for keeping site-specific developer services within PR24

As set out in our response to the PR24 consultation published in May 2021, we think that prior to removing site-specific developer services from the price control, Ofwat should be able to demonstrate that four key conditions have been met: namely that:

1. incumbents deliver a consistently high service levels of service to market participants;
2. reasonable margins are available to new entrants to allow them to compete;
3. any regulatory obstacles precluding a level playing field have been removed; and
4. sufficient competition is evident to protect new connections customers.

We do not think that any of these preconditions have been sufficiently demonstrated and note that Ofwat's assessment only considered the extent to which the fourth criteria presented above was met. We therefore think there is a strong rationale for Ofwat to revisit the analysis it completed to inform its draft PR24 methodology, and to progress

equivalent targeted assessments that are focused on better understanding the status of competition in terms of the remaining three preconditions.

We also have some reservations with respect to the assumptions that Ofwat has used to complete its assessment of the extent to which competition in the new connections market will be sufficient to protect relevant customers.

- **The constraint competition imposes on incumbent operation:** The assessment carried out by Ofwat focuses on the extent to which competition for the delivery of physical connections is evident and fails to consider the ultimate implications that this has in terms of constraining ongoing incumbent operations. While we acknowledge that there is some evidence of competition in the delivery of the physical assets required to provide a new customer connection, the reach of these competitive forces is more-often-than-not limited to activities that traditionally fall within the remit of an SLP. It could therefore be concluded that competitive pressures, and the subsequent constraints they impose on the activities of the incumbent, cease to have any real effect once the network becomes operational. If this is the case, the primary focus of Ofwat's assessment is on the extent to which incumbents effectively 'contract out' the delivery of the physical assets required for a new connection, and this only provides part of the overall picture.

If competitive pressures operate not only in relation to the design and construction of physical assets but also with respect to ongoing operation of the network, the scope exists for customers to receive a better service at lower cost across a larger portion of the value chain; with a potential corresponding increase in associated benefits. When considered within the context of the likely cultural attributes of new entrants, compared to incumbents, we think that there is greater scope for NAVs to innovate which could further enhance these benefits. Based on the assessment that it has carried out to inform PR24, Ofwat concludes that the monopoly status of incumbents in the provision of developer services is being eroded. However, this conclusion does not recognise that, in the majority of cases, incumbents will subsequently adopt, and assume ownership of, the assets in the longer term; which adds corresponding value to their RAB, and earns them an ongoing return.

- **Incumbents remain providers of monopoly services:** For a NAV to effectively offer to serve a new development with water and / or wastewater, it needs to secure bulk supply and / or discharge services from the incumbent. While we recognise that 'full service' NAVs do exist, examples of these are very limited. As such, even if we were to concede that incumbent market share in developer services was being eroded, it is clear that these companies still retain monopoly power in certain key respects. This is where preconditions 1 and 2, outlined above, become increasingly important and, our experience to date clearly demonstrates that these criteria have not been met.

While we acknowledge that there is a range in terms of both the levels of service and the available margins offered by incumbents, we still believe that there is room for all companies to make significant improvements in their performance. It could be argued that the levels of service we receive and margins available to NAVs are somewhat

subjective criteria as it is difficult to effectively measure what 'good' looks like in either of these areas. However, development of the independent connections market in gas and electricity provides us with a clear comparator allowing us to better understand what 'good' might look like in the context of monopoly provision of competitive services; and this analysis indicates that there is still some way to go.

- **Evidence that competition has developed to the extent stated:** The proposals that Ofwat presents around the removal of site-specific developer services from the price control are based on analysis carried out to inform its PR24 methodology. While the consultation refers to some of the high-level findings from this analysis, including the conclusion that developers / SLPs completed 98% of sewer connections and 53% of new water mains in 2020-21, the detailed analysis is not published and therefore it is not possible for interested parties to assess the validity of the findings. We would urge Ofwat to consider publishing a more detailed overview of its analysis to allow NAVs and other interested parties, to assess the basis upon which the regulator is proposing to remove developer services from the price control. Given the significance of the proposals in this area, we think it is only reasonable that we are given the opportunity to review the data that has informed Ofwat's decision to materially change the status quo. This would allow us to better understand the extent to which the analysis: accounts for differences in the respective size of the connections market in different incumbent regions; and considers how many SLP-led developments are subsequently adopted by the incumbent (recognising comments in the first bullet above).
- **Evidence that water and wastewater should be removed:** In line with the preceding bullet, we note that as we are unable to review the analysis that informed Ofwat's policy position on the treatment of developer services at PR24, it is not possible for us to fully understand the respective dynamics of the water and wastewater market. As outlined above, Ofwat concludes that in 2020-21 developers / SLPs completed 98% of sewer connections and 53% of new water mains. In and of itself, this suggests there is a marked difference between the water and wastewater developer services market in terms of the extent to which competition has developed. However, aside from looking at the impact of site size in terms of levels of competition, there is no analysis of the drivers underpinning the different findings in these markets. In fact, the proposals for the wastewater market are, in large part, replicated in water despite clear and significant differences in levels of competition in the respective markets. We think there is a rationale for exploring this further to better understand the key issues and ensure that any decisions ultimately taken do not have unintended consequences.

We are very concerned about the Ofwat proposal to remove developer services from the price control at PR24 and think that, if Ofwat ultimately decides to pursue this policy, it should at the very least complete an assessment of the extent to which the four preconditions, outlined in response to this question, have been met.

Potential implications of prematurely removing developer services at PR24

In line with our response to question 2.2. above, we acknowledge the very real benefits that could be attained from the removal of site-specific developer services from the price control.

However, a key caveat is that before removing market segments from the control, there needs to be persuasive evidence of effective market competition. This will not only ensure the sufficiency of competition in terms of protecting new connections customers but will also provide assurances that a level playing field exists that will enable participants to compete fairly in the market. These issues need to be considered within the context of the extent to which there is scope for the provision of a service within the market to be provided by either an incumbent or a NAV / SLP (i.e. services are contestable) or whether the nature of the work necessitates that it can only be undertaken by an incumbent (i.e. it is non-contestable).

We think that there are two key areas that fall within the scope of non-contestable services. The first is the provision of reinforcement works, which Ofwat is proposing to retain within the price control, and the second is bulk supply / discharge services which fall within the scope of site-specific activities and which Ofwat is therefore proposing to remove. We have significant concerns about the potential to remove bulk supply / discharge services from the price control at PR24 without fully assessing the competitive conditions in the market and / or incorporating any additional protections for NAVs / SLPs. As outlined above, we recognise that some 'full service' NAVs do exist but examples are very limited and therefore most NAVs will need to rely on the incumbent for the provision of bulk supply / discharge services.

If these services are removed from the price control at PR24, leading to a corresponding reduction in regulatory scrutiny, there is a risk that incumbents could seek to exploit their monopoly power via the prices they charge and that the level of service provided to NAVs could fall from the current baseline. We think two key mechanisms could help to inform an understanding of the likelihood that this risk will evolve into a material issue.

- **The cost reflectivity of bulk charges offered to NAV:** For a market to be perceived as offering a level playing field to incumbents and new entrant providers, it is important that associated charging structures are cost reflective. If cost-reflectivity of charging is evident, this would indicate that all operators in the market are able to compete on the same basis. Ongoing discussions via the BSWG suggest that these conditions have not been established in the new connections market. In this respect, an assessment of bulk charges indicates that incumbents have taken varied approaches in setting their bulk tariffs and the resulting range of margins available to NAVs could be a sign that many incumbents are not fully compliant with expectations on cost reflectivity.

We are optimistic that the recent publication of four working papers by the BSWG, and Ofwat's commitment to set an expectation of compliance with the principles contained within them, will facilitate a significant shift in the cost-reflectivity of tariffs for the 2023-24 charging year as well as an improvement in associated levels of transparency. However, any such shift in the arrangements, and the resulting competitive benefits attained, will come too late in the PR24 process to provide assurance that conditions in the bulk charging market have evolved sufficiently to protect market participants from monopoly charges. Removing regulatory protections too early will indicate to incumbents that the regulator considers current levels of charges to be appropriate and will therefore limit incentives to pursue further improvements in cost-reflectivity. In effect, this could mean that the benchmark for NAV charges is set at the wrong level as compared to that which would naturally emerge if competitive forces were given more time to evolve prior to removing developer services from the price control.

- **Levels of service provided by incumbents to NAVs:** While we welcome the introduction of the D-MeX, we note that it has highlighted varied levels of performance on the part of incumbents in terms of the provision of NAV / SLP / developer services; indicating that there is scope for some incumbents to further improve the performance they are providing. However similarly to the argument outlined in the preceding bullet with respect to charging, removing regulatory protections too early will indicate to incumbents that the regulator considers current levels of service to be sufficient and will therefore limit incentives to pursue further improvements. In effect, this will mean that the benchmark for services is set artificially low as compared to the level that would naturally emerge if competitive forces were permitted more time to evolve. We do not think that the period of time that D-MeX has been in place has been sufficiently long to conclude that there is no scope for further improvements in the levels of service that incumbents provide to NAVs / SLPs / developers.

Q3.3 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?

We think there is a strong rationale for establishing a separate revenue reconciliation mechanism for network reinforcement at PR24 to avoid creating incentives for incumbents to delay reinforcement work given the potential upsides associated with cost sharing.

Q3.4. 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 fewer 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 new connection customers from monopoly power?**

Please see our response to question 2.2 above. We would also note that if water site-specific developer services are removed from the price control, with some portion of the market subject to extra protections, this will create complexity in terms of managing and administering regulation. We think this provides a further argument for keeping developer services within the bounds of the price control until competition is fully developed.

Q3.6. Do you have any views on any other aspect of our proposals in relation to: (c) developer services?

We note the assessment that Ofwat includes within the consultation regarding the future treatment of income offset. In this respect, given its October 2021 decision to remove the ability for English companies to offer income offset from April 2025, Ofwat recognises the potential to formally introduce transitional arrangements. The regulator states that this would allow companies with high levels of income offset to phase out their removal.

Ofwat's ultimate decision is that transitional arrangements should not be used as they would unnecessarily increase regulatory complexity. Ofwat also sets an expectation that companies will communicate their plans in good time to enable SLPs and NAVs to prepare for any changes.

While we acknowledge the benefits of the proposed approach as it will avoid introducing unnecessary complexity, we think it will be important that Ofwat complements incumbent communications by providing clear messaging to housebuilders on this issue. This will ensure they understand the impact of the change and the timescales for implementation.

Questions in Chapter 5 – Delivering outcomes for customers

Q5.1. Do you agree with our proposed package of common performance commitments? Is water demand best incentivised through separate performance commitments on business and household consumption and leakage or through a performance commitment measuring total demand?

We very much welcomed the introduction of D-MeX at PR19 as a way to measure the performance of incumbents in delivering in line with agreed SLAs for developer services. Since its implementation, we believe that the mechanism has had a positive effect in terms of improving incumbent performance and has added weight to the efforts of NAVs to facilitate more responsive service provision. However, we do not agree with the Ofwat assertion that it is too early to consider potential changes to the D-MeX on the basis that there is only one full year of reporting data available.

We note that the Accent report: [C-MeX and D-MeX 2020-21](#) was completed in September 2021, and published on 5th October 2021. We therefore expect the results from 2021-22 to be available imminently and this would provide two years of reporting data on which decisions could be based. We are also keen to point out that Ofwat arguably only has one full year of reporting data available for any of the incentive mechanisms introduced at PR19 and, if the same logic were applied to the full range of performance commitments, it would not be possible for Ofwat to make any changes at PR24.

We acknowledge that C-MeX and D-MeX were new mechanisms implemented at PR19 and that Ofwat wishes to give them time to 'bed in'. If the mechanism was operating seamlessly this would not be of significant concern but there are a number of known issues with respect to the current structure of the mechanism which we think should be addressed at PR24. If changes are not implemented at PR24, this effectively means that we will likely have to wait until the end of PR24 (a further eight years) until these amendments are made. We think change is needed in the following three areas.

- **D-MeX targets:** Incumbent D-MeX targets should be set based on upper quartile actual industry performance in PR19; initially using data from the first two years of PR19 (2020-21 and 2021-22) and, later in the PR24 process, updating this to incorporate insights from 2022-23 performance. Taking point of connection / discharge (POC/D) performance as an example, the current D-MeX target is for delivery within

28 days but, if this were to be based on upper quartile performance from 2020-21, the targets would be significantly reduced to 19 or 20 days.

If changes are not made to reflect actual levels of performance and to incentivise companies to strive to reach the industry frontier, it is unlikely that they will prioritise improvements such as these during PR24. Given the potential implications that slowing competition in the NAV market could have for the 'levelling up' agenda (as outlined above in our response to question 2.2) we think these changes should be prioritised. This would also ensure consistency in terms of the more general approach that is taken with respect to performance commitments / ODIs across the price control.

- **D-MeX definitions:** In the process of working with the D-MeX mechanism, we have identified ambiguity with respect to a number of definitions related to the service levels that incumbents should meet. Where this ambiguity exists, it necessitates extensive discussion with the incumbent to reach an agreed position on the definition and this ultimately introduces further delay into the process. In addition, we are aware that where ambiguity around the definitions exists, this can give the incorrect impression that certain incumbents are delivering a high-quality service in a given area when, in fact, their good performance is indicative of a definitional difference as compared with their counterparts. It is therefore important that these definitions are reviewed, not only to avoid delays in the delivery of critical developer services to NAVs and SLPs, but also to ensure that incumbents are not inappropriately awarded or penalised for their performance based on inaccurate or incomplete information.
- **Customer representation in D-MeX surveys:** We note that at the time D-MeX was introduced, we expressed dissatisfaction around the underrepresentation of NAVs within the customer surveys given the value and volume of new connections that we deliver and the associated volume of services we procure from incumbents. Indeed, in the IWNL response to Ofwat's November 2021 consultation on PR24 Performance commitments for future price reviews, we referenced the D-MeX guidance which specifies that NAVs and SLPs can only be selected for interview a maximum of six times a year for each incumbent. We noted that this places insufficient weight on NAV and SLP views given that they are the primary customers that incumbents engage with on a large proportion of developer services projects. We proposed that D-MeX should recognise the total value of the work incumbents carry out for each group of developer services customers and weight associated customer sampling accordingly.

Our position on this issue remains unchanged; we would like to see Ofwat proposals in this area that more accurately reflect the importance that should be attached to the role of NAV and SLP views in informing an assessment of performance under D-MeX. We also note the interaction with the proposal to increase the incentives available under the C-MeX and believe that this could effectively further reduce the extent to which incumbents prioritise the delivery of a good service to its developer services customers by encouraging them to place more focus on good C-MeX performance.

We recognise Ofwat's commitment within the consultation to considering a review of D-MeX if it changes its approach to regulating developer services. We want to be clear that,

if Ofwat decides to remove developer services from the price control in PR24, a review and associated revision of the D-MeX arrangements will be vital. As outlined above in our responses to questions 3.2 to 3.4, we do not think that competition in the developer services market is sufficiently developed to warrant its removal from the price control at PR24. However, if Ofwat decides to remove this market segment from PR24, it will be critical to increase the scope and focus of the D-MeX to help ensure that sufficient protections are in place for NAVs and SLPs during the 2025-2030 period.

Q5.4. Do you agree with our proposed approach to the measures of experience performance commitments, including to increase the size of C-MeX?

While we welcome Ofwat's proposal to increase incentives under the C-MeX, recognising the value that should be attached to the delivery of high levels of customer service, we question why Ofwat has not decided to make an equal amendment to the existing D-MeX incentives. Both are measures of customer experience, and the proposed approach will encourage incumbents to place more focus on effective delivery against the C-MeX; potentially at the expense of performance under D-MeX. We think skewed incentives such as these could have unintended consequences and, recognising the proposal to remove developer services from the price control, do not believe that now is the right time to implement an approach that effectively deprioritises customer services for developers.

Questions in Chapter 6 – Setting expenditure allowances

Q6.8. Do you agree with our proposed approach to implementing nutrient neutrality in the PR24 framework?

We note that, following the publication of Ofwat's [methodology for PR24](#), on 20 July 2022 the government published a [Statement on improving water quality and tackling nutrient pollution](#) which set out the action government is taking to address issues in this area. In the statement, government committed to:

- **Table an amendment to the Levelling Up and Regeneration Bill**, with the intent of driving down pollution from all developments in catchments that are in unfavourable status due to nutrient pollution. The amendment would place a “statutory duty on water and sewerage companies to upgrade wastewater treatment works to the highest technically achievable limits by 2030 in nutrient neutrality areas” and require them to “undertake these upgrades in a way that tackles the dominant nutrient(s) causing pollution at a protected site”. Within the statement government asserts that “Wastewater treatment upgrades will reduce a significant source of nutrient pollution, helping to recover these crucial habitats, which will thereby reduce the level of mitigation required by individual developers when legislation comes into force”.
- **Establish a nutrient mitigation scheme**, by issuing a ministerial direction to Natural England in this area. Natural England will develop the scheme, with associated funding for required projects provided by Defra and DLUHC. The intended outcome of this initiative is the frontloading of investment in mitigation projects which will be

recouped via a simple payment mechanism where developers can purchase 'nutrient credits' that discharge any requirement to provide further mitigation.

In the subsequent [letter](#) from the DHULC to the Chief Planning Office on 21 July 2022, government indicated that these proposed measures should "significantly reduce the mitigation that new development has to secure" and make "access to mitigation far easier than it has been". We note that the Ofwat consultation includes inferences which suggest that it was aware that obligations of this nature could be introduced relatively shortly after publication of the draft PR24 methodology.

In this respect, in the PR24 methodology consultation Ofwat states that if an additional statutory requirement were to be placed on water companies with respect to nutrient neutrality, its proposal would be to treat nutrient neutrality mitigation as a price control activity. Ofwat goes on to state that in determining whether any investment would count towards nutrient neutrality mitigation, consideration would be given to whether the work is required to meet existing environmental obligations or whether it goes further than this. Ofwat therefore proposes that, in the former case, the costs would be recovered from customers while, in the latter, developers would be expected to provide a contribution.

We think, in light of the commitments government has made in its [Statement on improving water quality and tackling nutrient pollution](#), that the proposals in the Ofwat consultation infer an unduly onerous burden for developers. As such, as the proposals currently stand, developers would be expected to not only purchase credits under the nutrient mitigation scheme but also contribute to water company costs associated with their statutory duty to upgrade wastewater treatment works to the highest technically achievable limits by 2030. We think that this places an undue burden on developers, and also note the inconsistency with the position that Ofwat confirmed in its October 2021 decision document on the [Scope and balance of developer charges and incentives](#).

In this respect, in its conclusions on the scope and balance of developer charges, Ofwat confirmed that it would "retain the current arrangement that developers **do not** contribute to the costs of strategic assets, except where they take the form of environmental incentives". In this context, the reference to 'environmental incentives' captures incentives toward water efficiency and sustainable drainage. The rationale that Ofwat provides for its decision in this area is that "most costs of strategic assets are associated with population growth and would still be incurred under a counterfactual of no new development...[and] a growing population". We agree with this assertion and therefore do not consider that there should be an expectation, as part of PR24, that developers should provide a contribution to work on wastewater treatment plants necessary to meet future environmental obligations. We also note that an approach such as this could be counter to the achievement of the stated objectives of the 'levelling up' agenda which is discussed in more detail in our response to question 2.2 above.

We do accept that in its decision document on the [Scope and balance of developer charges and incentives](#) Ofwat refers to potential "instances where it would be in the commercial interest of developers to make contributions to strategic assets in order to address environmental requirements to support planning applications". To this end, Ofwat

states that “We do not wish to rule out changing our charging rules at some point in the future to facilitate this”. We assume that the inclusion of this reference was intended to allow flexibility to developers in terms of any commercial arrangements that they might chose to enter into rather than to provide the scope to require developers to pay the costs associated with water company strategic assets.