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3 August 2017

New connections charges for the future - England

This letter and associated appendix provides our response to the new connections charges consultation.

We support the development of charging rules for new connections. We consider that the introduction of new rules presents an opportunity to make a step change in the approach to charging, promoting clearer and more transparent charges to the benefit of customers. It also provides an opportunity to introduce incentives for developers to build water efficient and sustainable new homes. We have engaged over a number of years with a wide range of stakeholders including Defra, Ofwat and Water UK on the development of new connections charging. We have also started our targeted engagement with our stakeholders through a written consultation and a stakeholder event on proposals to change our charges in light of the new rules which are due to come into effect from 1 April 2018. We are currently considering the feedback we have received and plan to consult on more detailed proposals later in the year.

We agree with the importance of equivalence regardless of who is the provider of a new connection. We recognise the existing inconsistency in treatment of income offsets between parties across the sector, particularly for new appointment and variation (NAV) companies.

We have taken a lead within the industry by offering new appointees an income offset against the bulk supply agreement to ensure equivalence. We are currently working with a new appointee to provide such an offset and give further details of our planned approach in our detailed response to the consultation questions.

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an AWG Company

We have significant reservations about the detail of the proposals. In particular, we do not agree with the proposal to apply the income offset to infrastructure charges because of the impact this will have on our ability to introduce effective price signals to incentivise water efficiency.

To illustrate our concerns, in 2015-16, our income offsets outweighed our total infrastructure charges recovered by roughly £3m, with total income offsets being over 40% higher than infrastructure charges. As we develop our new connection charges we have been planning to use zonal infrastructure charges to send price signals to developers to locate developments efficiently. Additionally we are planning to provide incentives for water efficiency through the infrastructure charge. Promoting water efficiency is a priority for the Government, Ofwat and us.

It could also be detrimental to the cash flows for developers, because they would be receiving the benefit of income offsets much later than is currently the case. In the case of developers/NAVs investing to prepare sites which are subsequently parceled and passed to house builders the developer/NAV would no longer receive the benefits of offsets as they do now.

One way to avoid removing this price signal would be for the proposed interim arrangement under option three to be the enduring regime (i.e. NAVs receiving an income offset again the bulk agreements). This would have the added benefit of avoiding changing the timing of providing the offset to developers, maintaining existing cash flows. We believe Ofwat should consider this amendment as part of its reflection ahead of finalising the charging rules.

We trust these comments will help develop the final version of the charging rules and licence. Please do not hesitate to get in contact if you wish to explore anything further. Arun Pontin (aPontin@anglianwater.co.uk 07973 965537) would be a good point of contact in the first instance.

Yours faithfully,

Jean Spencer
Strategic Growth and Resilience Director

New connections charges for the future - England

Question 1: Do you agree that our Option 3 on the treatment of the income offset/asset payments, has merit? If not, please explain your reasoning and provide relevant evidence. If so, how and when should this change be brought about?

We fully support the principle of equivalence regardless of the provider of new connections. We recognise the existing inconsistency in treatment of income offsets between parties, particularly for a NAV. We have taken a lead within the industry by offering new appointees an income offset against the bulk supply agreement. We are currently working with one new appointee to provide such an offset and give further details of our planned approach in our detailed response to the consultation questions.

We have some reservations about the detail of the proposals, particularly related to our ability to send economic and water efficiency signals through infrastructure charges.

Our approach to offering income offset to NAVs

As outlined in the cover letter, we are already offering a NAV an income offset. Our income offset for NAVs will apply to the offsite requisitionable costs where we provide the assets. This will be for both offsite works and contributions towards strategic schemes. Income offset will be applied to the total cost for offsite and/or strategic work and is based on the expected Wholesale income from the bulk supply/ bulk discharge to and from the site. This will be calculated using our large user tariffs, as per our Wholesale Charges Scheme. We consider that offsetting this wholesale income, rather than end user charges, to be the most appropriate approach as it accurately reflects the income we receive as a result of the demand from the site.[1] To apply the offset, we will use the Relevant Deficit/ Discounted Aggregate Deficit approach as is currently applied to developer charges.

Infrastructure charges are also applied, and it is expected that these would be equal to the amount of infrastructure charges collected by the NAV Company. No income offset is applied to the infrastructure charge under the current approach.

[1] The income offset should reflect situations where we would not receive all the revenue from a new appointment's site.

Figure 1 represents how the total costs to the NAV are calculated in a building block approach. Our understanding is that the approach outlined above aligns with Ofwat's interim measure in its preferred option in the consultation (option 3).

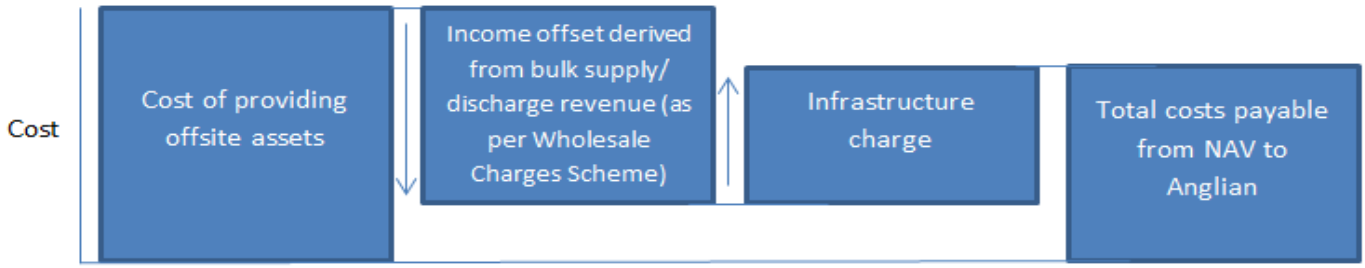

Figure 1: *the building blocks of our approach to applying an income offset for NAVs*

We would be very happy to discuss the approach we have developed in detail with Ofwat.

Income offset against infrastructure charges

We support the proposal to ensure that NAVs benefit from income offset.

However our income offsets outweigh our infrastructure charges by a significant proportion, with total income offsets being over 40% higher than infrastructure charges in 2015-16. Moving the income offset from requisition charges to infrastructure charges could mean that in practice we no longer charge infrastructure charges. We note that other changes to the charging rules will increase the relative size of the infrastructure charge but the net effect of both changes are not yet understood.

We have been planning to use zonal infrastructure charges to send price signals to developers to locate developments efficiently through our new connection charges, as well as providing discounted infrastructure charges for water efficient and sustainable homes. Applying the income offset to infrastructure charges will remove our ability to send this signal.

Promoting water efficiency is a priority for the Government, Ofwat and us. Defra's Strategic Priority Statement and more recently a letter from the Secretary of State for the Environment, Food and Rural Affairs clearly sets the challenge for us to promote water efficiency, with the aim of reducing overall water consumption.

Our region is one of the driest in the UK – we receive around two thirds of the average rainfall for England and Wales. Climate change, economic growth and changes to our abstraction licences make the challenge of

securing future water supplies particularly acute for us. We are taking this challenge seriously and water efficiency is an important part of our Water Resources Management Plan (WRMP).

One approach to promoting water efficiency we have been planning is by providing incentives to homebuilders to promote water efficiency. Considerable effort has been expended in building this into our new charging regime. Figure 1**Error! Reference source not found.** shows our proposed charging scheme that we consulted on earlier in 2017 – this is subject to further development and consultation.

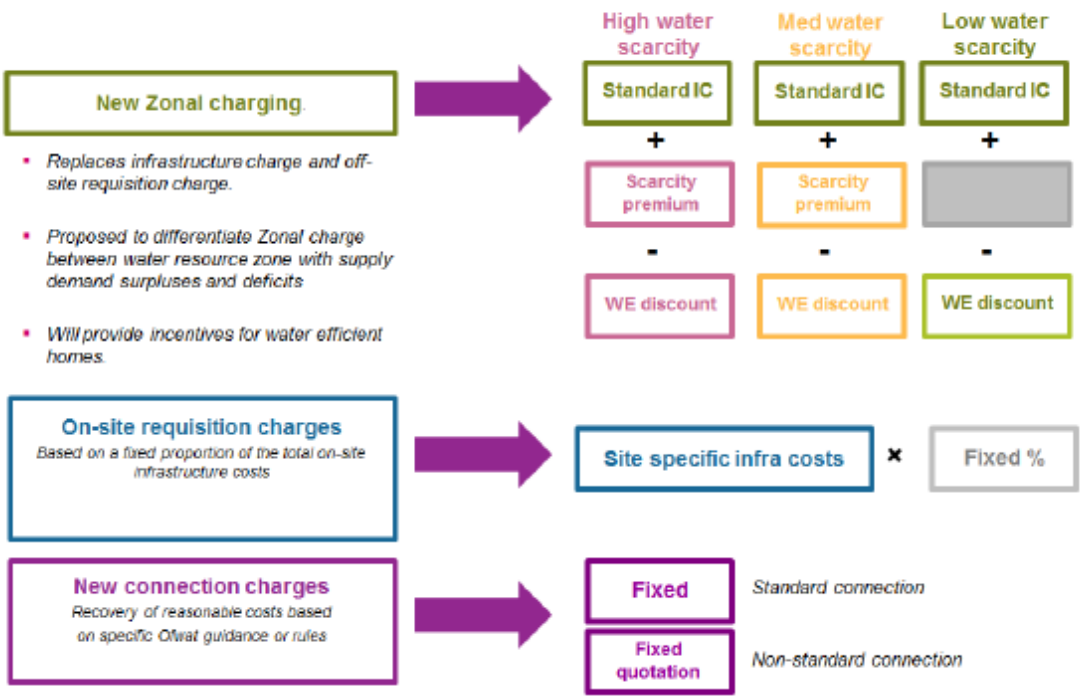

Figure 2: *potential new connection charges, with water efficiency discounts*

We note that the changes to the charging rules already enacted allow infrastructure charges to be negative and for companies to provide payments to customers. We believe this would be more complex and potentially less effective than a discount against a 'full' infrastructure charge for achieving the desired efficiency outcome. Water companies could also be drawn into negotiations about correct payment levels for certain solutions rather than leaving developers and house builders to innovate to reach the target consumption level.

It would be disappointing if we were unable to provide effective incentives for developers, with knock on implications for our ongoing work on connections charging and the WRMP.

We believe there may also be implications for developer cash flows from the proposed change. Generally, infrastructure charges are collected later in a development's lifecycle than requisition charges (or indeed the bulk supply and discharge agreement). If we provide the income offset against infrastructure charges we may delay the developer's and NAV's receipt of the income offset, affecting their cash flow.

Altering the timing of the offset may also change the party that receives the offset. On some sites, developers will prepare the land including paying requisition charges before selling plots to house builders. In these situations, the party that benefits from the income offset would be house builders rather than the land developer. We believe the impact on cash flows and the recipient of the offset should be explored with the affected stakeholders as part of Ofwat's considerations.

One way to avoid removing our ability to send economic and efficiency price signals would be for the transitional arrangements (i.e. applying the income offset for NAVs against the bulk agreements and not changing the arrangements for other parties) under option three to be the enduring regime. We believe Ofwat should consider this alternative as part of its reflections ahead of finalising the charging rules.

Question 2: Do you agree with our draft impact assessment? Can you provide quantitative figures in terms of the potential benefits or costs? Is there anything we have missed?

It is helpful to see Ofwat's impact assessment for the proposed change to the charging rules. We have reviewed the impact assessment and believe the level of detail and balance of qualitative and quantitative analysis is proportionate. We do not have any detailed comments but note that, as outlined above, if income offsets mean that in effect infrastructure charges no longer apply it will be harder for companies to incentivise water efficiency or other beneficial behaviours in customers and developers. We believe the final impact assessment should include the option we have identified in our response to question one.

It may also be appropriate to consider the timing of cash flows to developers and NAVs in the assessment.

Question 3: Do you have any comments on the drafting of the possible future changes to our rules (set out in Appendices A3 and A4)?

We have reviewed the proposed rule changes. We believe they achieve the desired outcome in Ofwat's proposed approach. If our other approaches are pursued, these rule changes would need to be revisited.

Question 4: Do you have any comments on our proposed licence modification to Condition C (Infrastructure Charges) for English water companies other than NAVs (including the proposed wording set out in Appendix A7)?

We have reviewed the proposed modifications to Condition C. We believe the drafting is clear and we have no detailed comments. If other approaches are pursued, these licence changes would need to be revisited.

Connection charging update

We note Ofwat's comments regarding the implementation of new connections charges by the industry. Earlier in 2017 we consulted and held a stakeholder event on our proposals for new connections charging. Our proposals focused on high-level principles of our charging regime and we received good engagement from stakeholders. We are planning to consult and hold another stakeholder event on our detailed proposals later in 2017.

We support the upfront publication of some charges and are committed to providing developers information that will allow them to make timely and informed decisions. In some instances, the provision of one-size fits all charges may not support effective decision making by developers. We think in certain situations it is far more useful for developers and NAVs to discuss potential options and costs with companies than to plan based on inaccurate fixed charges. As such we support the proposed principles based approach to exemptions; not withstanding the need for timely engagement.

We have some reservations about the proposed reporting of exemptions from upfront publication of charges in the annual performance report. The ability to provide and use upfront charges is partly driven by factors outside of a company's control, e.g. whether the new development is near existing infrastructure. We do not believe that quantitative reporting alone will be insightful. We are concerned about how such quantitative reporting might be used in the assessment of business plans during PR19, especially if it is not accompanied by appropriate narrative.