



Charging team  
Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham  
B5 4UA

**AnGLIAN Water Services Ltd**

Lancaster House  
Lancaster Way  
Ermine Business Park  
Huntingdon  
PE29 6XU

[www.anglianwater.co.uk](http://www.anglianwater.co.uk)

28 May 2019

Dear Charging team,

Please accept this as our response to the consultation on charging rules for new connections and new developments for English companies from April 2020.

We support Ofwat's on-going work to improve the regulatory framework for new connections and agree with the principle of equivalence regardless of provider. We agree that the proposed policy improves equivalence. We have also been proactive in trying to improve equivalence, in particular in developing our new connections charges from 2016 that were launched last year. We believe charging reform has been helpful to the sector as a whole.

We therefore support the direction of the proposed policy, but remain concerned about some of the practical implications as outlined in our 3 August 2017 consultation response. In particular, we are concerned about the negative impact on cash-flow for both developers and self-lay providers (SLPs).

We are committed to enabling sustainable economic and housing growth in our region. The changes and cash-flow impacts could have consequences for the housing market, the competitive market for connection services and so for customers. We would suggest that Ofwat consider what amendments to the proposals could be made to mitigate these consequences.

We provide our views against each consultation question in the annex to this letter. If you have any questions in relation to the above responses, please do not hesitate to contact us.

Yours sincerely,



## Consultation on charging rules for new connections and new developments for English companies from April 2020

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### Worked examples – implementation issues

We believe it helpful to provide a worked example showing our current understanding on how the proposed changes to the charging rules will affect our charges and payments. We refer back to these examples in responding to the consultation.

The examples are stylised to demonstrate the impact for developers and SLPs in our region on a theoretical single site. The examples cover only requisition charges, zonal charges (our name for infrastructure charges) and the income offset. Financial figures are presented in real terms and we have assumed no changes in the zonal charge for simplicity. We have also made the following assumptions:

Parameters	Assumption	Comments
Requisition cost	£100,000	Example only
Zonal charge	£450	Approximation of current charges
Income offset (current arrangements)	12%	Contribution percentage to requisition costs, reflecting the historic balance of charges.
Asset payment	88%	Inverse of contribution percentage, reflecting the historic balance of charges.
Income offset per plot (new arrangements)	£251	Illustrative estimate of income offset, based on 12% of the requisition cost applied per plot.
Number of properties	350	
Build out rate (years)	10	

### *Impact for developers*

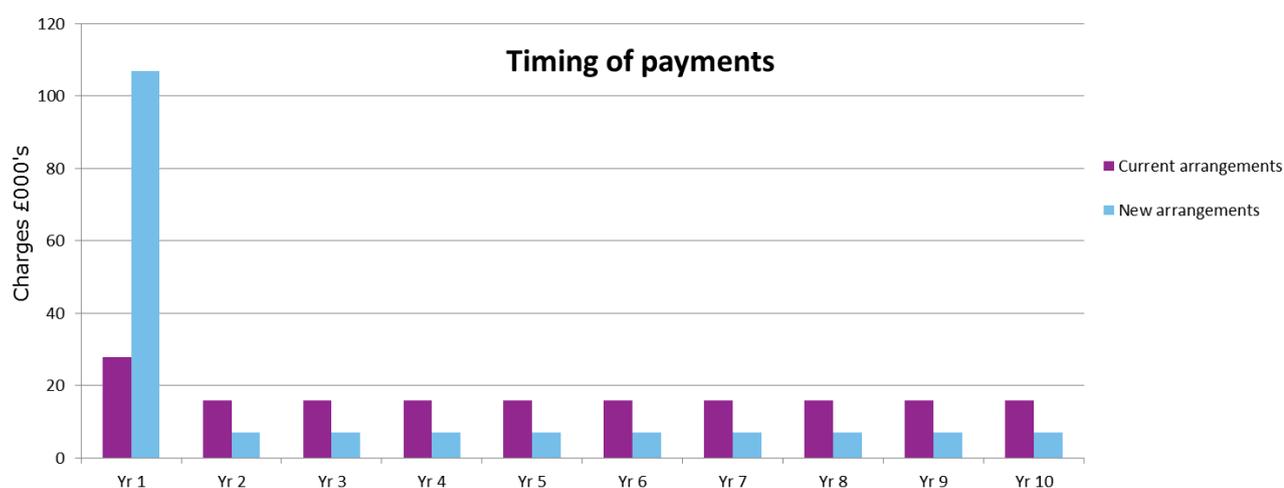
While the balance of charges for the development remains stable, the cash-flow impact is significant. This is shown the value of charges payable in the first year of the second table, which shows charges payable.

While the balance of charges over the life of the development are the same, the charges payable in the first year of the development **increase from £28k to £107k**. This is due to no longer receiving the income offset against the upfront requisition costs.

Item	Current arrangements	New arrangements	Comments
Requisition cost	£100,000	£100,000	
Upfront charges	£12,000	£100,000	Under the current arrangements, the developer pays 12% of the upfront costs. Under the proposed rules, the developer will pay 100% of the upfront cost.
Zonal charges	£157,500	£69,500	Under the current arrangements, the developer pays the full zonal charge. Under the proposed rules, the developer receives a discount to the zonal charges to reflect the historic balance of charges.
<b>Net total</b>	<b>£169,500</b>	<b>£169,500</b>	The balance is the same. However the timing of payments is drastically different.

Charges payable	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Current arrangements	£28k	£16k								
New arrangements	£107k	£7k								

This is also shown in the chart below.



### *Impact for self-lay providers*

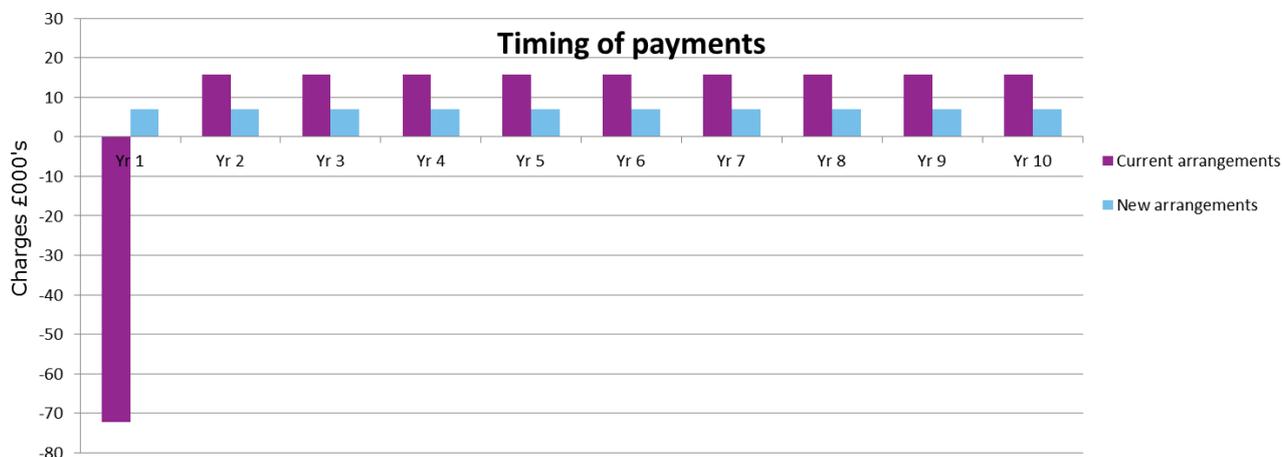
While the balance of charges remains stable over the life of the development, the cash-flow impact is significant. This is shown in the value of charges payable in the first year of the second table, which shows charges payable. Instead of receiving the asset payment in the first year, the income offset is provided through discounted zonal charges.

Despite the balance remaining stable, the SLP and the developer no longer receive a payment in the first year but must instead cover the costs of the construction and pay zonal charges. This is due to no longer receiving an asset payment to the value of 88% of the requisition costs.

Item	Current arrangements	New arrangements	Comments
Requisition cost	£100,000	£100,000	
Upfront charges	£-	£-	SLP pays no requisition costs.
Asset payment	-£88,000 (payment to SLP)	£-	Under the current arrangements, the SLP receives an asset payment of 88% upfront. Under the proposed rules, the SLP will receive no asset payment.
Zonal charges	£157,500	£69,500	Under the current arrangements, the customer pays the full zonal charge. Under the proposed rules, the customer receives a discount to the zonal charges to reflect the historic balance of charges. The nature of the contract between SLPs and developers will need to change to allow appropriate credit for discounted zonal charges.
<b>Net total</b>	<b>£69,500</b>	<b>£69,500</b>	The balance is the same. However the timing of payments is drastically different.

Charges payable	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
Current arrangements	-£72k	£16k								
New arrangements	£7k	£7k	£7k	£7k	£7k	£7k	£7k	£7k	£7k	£7k

This is also shown in the chart below.



### Impact for land developers

Another group of customers impacted are land developers. They secure planning for some of our largest development sites (such as Alconbury in our region). They construct the primary infrastructure (spine mains) and sell parcels of land on to house builders. Land developers therefore pay for some of the requisitioned mains but not zonal charges.

Currently, land developers receive income offset from their requisition mains. However under the new approach they will pay 100% and their previous offset income will be passed to the house builder.

Item	Current arrangements	New arrangements	Comments
Requisition cost	£100,000	£100,000	
Upfront charges	£12,000	£100,000	Under the current arrangements, the developer pays 12% of the upfront costs. Under the proposed rules, the developer will pay 100% of the upfront cost.
Zonal charges	n/a	n/a	The Land Developer does not construct the houses and does not pay Zonal Charges
<b>Net total</b>	£12,000	£100,000	

The house builders, but not the land developer, receive the income offset through the zonal charge which maintains the broad balance for development in the long term.

**Q1:** Do you have any comments on the proposed wording for the New Connection Rules and Charges Scheme Rules (see Appendix 1 tables, and the rules for consultation), which will come into effect from April 2020.

Overall the drafting appears reasonable to implement the policy intent.

Under the new charging regime the “income offset” is the main tool that companies have to maintain the broad balance of charges. For us, it is no longer an offset linked to expected income but represents the impact the offset had historically on the balance of charges. Placing the term in the charging rules encodes this historic terminology and does not reflect the reality of the offset. Continued use of the term could be misleading for customers, who may expect the offset to reflect income linked to their specific site rather than an adjustment to maintain the broad balance. This could lead to increased instances of unnecessary complaints and determinations.

We believe one area where additional clarity could be provided is on the balance of charges. Given the impact on cash-flow, the drafting could clarify whether balance rule applies over the life of a development or in a specific year and whether it should account for cash-flow impacts.

We note that the proposed changes explicitly prohibit the provision of the income offset against requisition charges and remove references to asset payments. We believe the changes result in a significant cash-flow impact (see our examples), which could be managed through transition arrangements. However the stark drafting of the proposed changes severely limits the potential options for transition arrangements. Alongside our comments on

implementation, Ofwat may wish to temper the definitive nature of the proposed drafting to provide more flexibility during transition.

**Q2 (a):** Do you have any comments on our proposal to introduce an information requirement on bill stability? More specifically:

- Do you find the proposed requirement helpful in supporting the charging principle of bill stability?
- Is the suggested 10% threshold for significant bill increases appropriate for striking the right balance between more scrutiny on bill increases and flexibility for companies to make changes as necessary?

We recognise that such a provision may be helpful for customers. However we cannot comment in detail without seeing proposed drafting from Ofwat. As would be the case if this requirement were implemented through the charging rules, Ofwat should consult on the wording of the notice before finalising it.

We believe that the 10% threshold is reasonable and agree it should be higher than the 5% threshold for main charges. We propose that this could be 10% after accounting for inflation to reflect the different nature of infrastructure costs to other charges and costs. We should also be mindful of the interaction with the requirement that charges are cost reflective which may conflict with certain mitigations.

We believe additional clarity is needed in the description provided. In particular it's not clear whether the requirement would be relevant for the balance of payments for a development, the individual charges themselves or a combination of the two accounting for the income offset.

For us, the changes to the income offset required by the charging rules will result in a significant change in the charges paid upfront by developers and other types of customer. However we would expect the balance of payments over the life of the development to remain the same. This is shown in the worked examples. Ofwat should clarify how they expect this to be reflected in the new requirements on bill stability.

**Q2 (b):** In order to assist companies in implementing this requirement effectively, we welcome views on:

- what criteria would be most appropriate to define typical new developments; and
- what services should be included in a typical package.

There are rarely 'typical' developments and what's typical can vary significantly across the country. In our region, we have a larger number of major new town type developments. These new sites tend to be in more rural areas and tend to

be larger than average across the country, with consequently more significant infrastructure requirements.

At our session with Ofwat's PR19 team on 30 April, we discussed how the growth pressures in our region in AMP7 are significant, and the nature of this growth drives costs differently than in other parts of the country. We committed to provide further evidence in support of this difference which we will do shortly following the completion of further analysis, including further econometric modelling of the drivers of growth expenditure.

We are comfortable that the requirement be applied to individual unit charges subject to the Charging Rules for New Connection Services (English Undertakers). We undertook a review of the changes to our charges on this basis for 2019-20. This approach would remove the need to define a typical development.

### Interactions with PR19

We are mindful of the interaction of the rule changes with the PR19 process. We note from the draft determinations for fast track companies that Ofwat has outlined an industry standard recovery rate for grants and contributions. We are concerned that this approach is at odds with charging rule that requires the broad balance of charges be maintained.

We also note that Ofwat amended negative zonal or infrastructure charges (where companies believe income offsets will outweigh the charges) to zero in its draft determinations. It is important to remember that the zonal charge reflects contribution to network reinforcement where for us and likely other companies, the income offset that will now be set against zonal charges also reflects on-site or site specific work. As such it shouldn't be expected that income offsets could never exceed the value of zonal charges.

We would urge Ofwat to review its approach to cost allowances for growth and developer services in PR19 to ensure it is aligned with its charging policy.