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By email

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A consultation on the scope and balance of developer charges and incentives

This is Anglian Water's response to Ofwat's consultation on the scope and balance of developer charges and incentives.

Anglian Water's purpose is to bring environmental and social prosperity to the region we serve. We support Ofwat's ambition to encourage companies to offer environmental incentives through their developer charges and monetise environmental externalities. This should work in concert with other, potentially more powerful tools e.g. building regulations, to deliver best environmental outcomes. Our experience with providing discounts to developers for water efficiency suggests the most effective solutions are at a development scale.

We support Ofwat's on-going work to improve the regulatory framework for new connections, to encourage sustainable growth and facilitate markets. We agree with Ofwat and Frontier Economics' that the economic rationale for the balance of charges rules and income offset is unclear. However, we note that this a potentially significant change which may create incidence effects for different types of customers and home-buyers: we encourage Ofwat to consider these further as part of a regulatory impact assessment.

For the remainder of AMP7 the interaction between the legacy rules around the balance of charges, new rules relating to cost reflectivity and potentially an additional set of rules relating to environmental incentives must be clarified. To enable charges to be set in a timely manner for 2022/23 the relevant charging rules must be established during the summer. Setting cost-reflective environmental incentives will take time: to gather data to inform charges; consult with customers; refine the proposals; and undertake the relevant governance and assurance processes. Therefore, we propose that Ofwat encourage companies to offer environmental incentives and share best practice ahead of setting charges for 2022-23 but any new rules introduced should take effect from 2023-24 at the earliest.

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,

[redacted]

Alex Plant
Director of Strategy and Regulation

Annex 1 – question responses

1. Do you have any comments on key conclusions from the Frontier Economics report?

1.1. Strategic assets & the income offset

We agree with the cost causation principle, outlined by Frontier Economics, that states developers should contribute to the additional costs required to serve new developments. For some remote or significant developments, it may be possible to distinguish costs associated with new developments. Cost causation is generally the fairest way to charge for services and aligns with our purpose of bringing social and environmental prosperity to our region.

However, our experience with the Wing strategic main shows that in general, it can be difficult to differentiate and assign cost between customer types. Forecasts of growth with or without new developments are sensitive to the assumptions that drive them and designing infrastructure for two scenarios can be costly, design costs are typically 10-20% of total scheme costs.

We agree that the economic rationale for the income offset is not clear. We note that for a number of years companies have not benefitted from additional revenue due to the price control revenue cap.

However, we would urge caution with undertaking this reform without further consideration and understanding of the reason for its initial introduction. Removing the income offset is a considerable step which may impact different groups of developers and home-buyers in different and unexpected ways. We would encourage Ofwat to engage directly with the groups of customers most affected and undertake an impact assessment of these proposals. If these additional costs are passed on to home-buyers,[1] the contribution to new infrastructure by a home-buyer buying a new home in 2026 could be quite different to the costs faced by a home-buyer in 2018 or pre-privatisation of the industry. As it will increase the costs faced by some developers, it may not align with wider Government policy relating to home-building and the post-Covid-19 economic recovery.

The function of the income offset is currently to maintain the balance of charges; it was derived from a historic calculation of the discounted aggregate deficit, so was not set based on costs. Therefore, we think it unlikely that the income offset could be set based on cost reflectivity[2] and maintain the balance of charges. We agree with Frontier Economics that companies do not benefit from economies of scale due to new connections.

Similarly, while it may be possible to use the income offset to send environmental signals, any signals would need to reflect costs avoided to ensure they align with the expected new rules

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[1] We note Frontier Economics state that house prices are market driven, but markets do not always operate perfectly an additional fixed cost for all new properties across swathes of the country may affect prices.

[2] We note that the exact requirements of the charging rules relating to cost reflectivity have not yet been consulted on by Ofwat. Additional clarity of these new requirements, such as the level of granularity that will be applied would aid companies in developing charges for 2022/23 in a timely manner.

relating to cost reflectivity. Developing effective incentives in this manner will take time to gather data, develop options, reflect in charges, engage with customers and assure.

1.2. Network reinforcement

While there are some merits to more zonal charging, we believe these are outweighed by the benefits of a simple charge per connection. This is simpler for customers and it also allows companies to invest because of need to facilitate development and economic growth. In a more direct contribution model there can be hestitancy to be the first mover and there is less clarity around costs which can delay development and economic activity. This can be the case in electricity for example.

Our experience of zonal charging was that areas with more growth and investment tend to have more connections so there was not a large variation between infrastructure charges per zone. The zones would need to be very granular to send effective price signals but this becomes complex for customers and costly to administer. Zonal charges add complexity to the task of balancing costs and revenues.

We do however believe that further thought should be given to the time-horizon over which the requirement to balance cost and revenues applies. A five year time horizon does not align closely with the life-cycle of larger developments nor our planning horizons. For example, a large development with an uncertain 20 year life-cycle requires significant network reinforcement goes ahead in a given year. The charging rules require the company balance costs and revenues for the previous four charging years plus the next charging year, meaning the company would seek to recover all the costs in the next charging year. We believe this should be extended to at least 10 years with both a forward and historic view considered. We note that the rolling five year period under the rules does not align to the asset management periods (AMPs) in any event so the rationale for a five year period is unclear.

2. We seek views on our reasoning and proposals with respect to charges for strategic assets, income offset and the balance of charges rule

2.1. Strategic assets

When planning our investments, it is population growth rather than new connections that drives capacity planning. However, it is less clear whether there would be population growth in the absence of new development in general. The trends of development and population growth may be affected in both the short and long-term as living and working preferences change as a result of the Covid-19 pandemic. To delineate this and create clear and fair charges would be difficult, as discussed above.

We agree that for now, the current approach should be maintained where it is not possible to differentiate between population growth and new development as the cause of asset enhancement.

2.2. Income offset

We agree that the economic rationale for the income offset is not clear. As noted above, removing the income offset is a considerable step which may impact different groups of developers and home-buyers in different and unexpected ways. We would encourage Ofwat to engage directly with the groups of customers most affected and consider the impacts carefully.

2.3. Network reinforcement

We agree that the simplicity of the current approach delivers many benefits and is favoured by customers. This is consistent with the wider approach to charge setting for water and water recycling services where costs are socialised across customers and through time.

We are not convinced that there should be a requirement for bespoke infrastructure charges for remote or expensive to serve developments. Introducing this approach would be difficult to implement, as a unit rate for a driver that is cost reflective while likely be site specific increasing complexity for customers. There's a risk that this would create very expensive infrastructure charges for remote or difficult developments, potentially discouraging development in areas that would potentially benefit most from development. We do not believe that the benefits of such an approach have been demonstrated.

3. What environmental incentives should water companies be offering developers and NAVs? We are interested in examples of good practice. How can we better support this?

Anglian Water's purpose is to bring environmental and social prosperity to the region we serve and as such we fully support the principle of encouraging developers to go further on opportunities to improve the environment. We believe that to achieve this outcome environmental incentives should be considered in combination with the government's programme to improve housing and development standards and through water bills themselves.

There are some simple but critical actions government must take to enable all stakeholders - including regulators, local authorities and housing developers - to help improve the sustainability of the built environment. These will help reduce flood risk, cut water demand, increase energy efficiency, and improve river health whilst helping to meet the UK's net zero target. In order to deliver the necessary change, the frameworks governing the built environment must be underpinned by rigorously enforced, ambitious minimum standards, which also allow and incentivise developers and local authorities to go further where needed. This should include:

- Government **tightening Part G of Building Regulations to apply a 100 litres of water per person per day standard or below for new homes**, and outlining a clear timeline to tighten this further to 85l/p/d in time. This should also include the measures to reduce wider water consumption that Defra consulted on in 2019, and to which there has yet to be a government response.
- Allowing local authorities to set **tighter water efficiency standards under local planning policies where there is high growth in areas of water stress to make the best use of constrained water and environmental capacity**. This should be a key policy requirement of identified growth areas such as the Oxford-Cambridge Arc which

could see up to one million new homes built by 2050 within areas already at severe water stress.

- **Ensuring that new housing development and highways authorities adopt a natural-by-default approach to drainage and flood risk management, particularly in relation to surface water.** This would keep surface water, which does not require treatment, out of combined sewers. Excess run off entering sewers heightens flood risk to homes and increases the likelihood of discharges from storm overflows into rivers. This should be done through increasing (or even mandating) the take up of Sustainable Drainage System (SuDS) in both new development and maintenance projects by highways departments.
- **Remove the automatic right for developers to connect surface water drains to combined sewers.** This should be done through commencing Schedule 3 of the Flood and Water Management Act 2010. The automatic right to connect has been removed in Wales, and SuDS are a requirement in new development in Scotland. A May 2020 review commissioned by Defra concluded that the approach adopted in England to deliver and maintain effective sustainable drainage systems is insufficient and not fit for purpose.
- **Adopt a new, mandatory SuDS national standard that is aligned with the SuDS specification set within the water industry's Design and Construction Guidance.** The current planning-based approach to SuDS does not work because whilst SuDS are encouraged, it is all too easy for developers to either not build them at all, or to build grey underground SuDS to a poor standard that falls into disrepair. Improving the national standards and making them mandatory will enable water companies to adopt and maintain SuDS, with customers having to pay no more than they already would through drainage charges, and possibly less if the system does not itself drain to a sewer.
- **Introduce a right to connect new surface water to existing surface water drains.** This would allow water companies and other drainage authorities to connect surface water drainage to other surface water systems, like rivers and canals. Currently this is often subject to fees which make it cost-prohibitive. By allowing surface water to surface water discharge, there would be additional carbon reduction benefits as it will reduce the amount of unnecessary water treatment. Such a power would also relieve pressures on existing infrastructure if there were greater options automatically available for water companies e.g. to alleviate flooding.

3.1. Our experience

Our experience and engagement with the development sector suggests that in a period of post-covid economic uncertainty and rising building costs the housing market responds best to standards applied widely that create a level playing field and certainty. As such environmental outcomes will be best achieved by changes to building regulations and planning requirements as noted above.

We have, however, extensively explored approaches to influencing behaviours of all types of developer customers to deliver environmental outcomes. This includes discounts for water efficiency through developer charges from April 2018 to March 2020, where homes built to a certain standard 100 l/p/d were exempt from paying the infrastructure charge.

Our experience from applying these discounts is that price signals to developers are not the most effective form of influencing behaviour change. The feedback we received suggested that the discount we provided, while a large proportion of our developer charges, was an insufficient reduction when compared to the costs of delivering a home to higher levels of water efficiency, estimated to cost around £3,000 per home. Instead of being a catalyst for change we found that those developers taking advantage of the discount were either including water efficiency measures for other purposes (such as marketing or a planning requirement) or by the nature of the development such as flats and apartments anyway. The incentive in itself was not influencing the behaviours of a significant number of home builders. For water efficiency we found that an incentive-based approach also requires administration to confirm products are installed as per design and that homeowners will be encouraged to keep them after the initial house purchase.

Despite the challenges experienced so far, we believe that incentivisation approaches targeted at a site wide scale could, as part of managing the impact of the development, lead to developers including more multi-functional drainage features, reuse systems or offsetting demand through retrofit elsewhere. Such measures are also likely to become part of the distinctiveness of sites and will remain during the lifetime of the development.

As we have commented above an effective approach that deliver material benefits for developers, communities, environment, and companies will need sufficient time to explore the feasibility against other drivers and regulation, consultation and implementation. We suggest that this could be met by targeting AMP8 and link with the Home Builder's Federation Future Homes Taskforce and proposed delivery hub, of which Ofwat is a member.

We believe Ofwat should consider wider opportunities for using charges and tariffs to send environmental signals, for example through water bills themselves as part of PR24.

3.2. Charging rules

Charging will be just one of many ways to influence the behaviours of developers. However it is currently difficult to see how these rules would work in practice alongside the rules relating to the balance of charges and the expected updates to the charging rules in relation to cost reflectivity. It is not clear whether on-site discounts should be cost reflective of the upstream (downstream re sewerage) costs saved or should they be "signalling" the desired behaviour even if that means they are creating a cross-subsidy.

While it may be possible to use the income offset to send environmental signals, any signals may need to reflect costs avoided to ensure they align with the expected new rules relating to cost reflectivity and must remain within the balance of charges rules. The level of discounts would therefore be very sensitive to the assumptions made about take up and future activity and it would appear very difficult to maintain the balance of charges in practice until 2025.

Developing effective incentives in this manner will take time to gather data, develop options, reflect in charges, engage with customers and assure. As the industry has yet to see the proposals around cost reflectivity, we do not believe there is time to robustly implement rules on environmental incentives to take effect in the 2022/23 charging year. We would urge Ofwat to consult further on its detailed proposals and look to implement them later in AMP7, potentially even from 2025/26. This supports stability in charges for developer customers in the short term during the recovery from Covid-19.

In the interim while new rules are being established, Ofwat could highlight best practice and provide additional guidance on the types of incentives that could be offered.

3.3. Markets

The introduction of these incentives could have significant implications for NAV tariffs regarding the onsite costs avoided for the site, and would suggest that the objective of most market participants (NAVs and incumbents) for simplified, averaged charges may be frustrated, given a site with higher on-site costs allowing lower upstream costs will need a higher “minus” to ensure an appropriate tariff (and this might be on a sub-regional basis i.e. by Water Resource Zones).