

November 2018

Trust in water

Revisions to NAV Policy Guidelines

About this document

New Appointments and Variations (NAVs) are new entrant water and wastewater companies which serve end customers by becoming the local licensed supplier and replacing the existing incumbent for a specific area.

NAVs can compete with incumbents to supply infrastructure and retail services to new build development sites not served by, or with the consent of, the current incumbent. They can also compete to supply large users (customer taking more than 50MI/d in England, or more than 250MI/d in Wales).

In this document, we consider whether our existing policy for NAVs remains appropriate. We have identified a number of areas of our existing guidance which requires updating. However, we think that the principles underlying the guidelines remain appropriate.

We have held a number of discussions with NAVs and other relevant parties in preparation for this document.

Any person who wishes to make representations with respect to the revised policy statement should do so in writing to the NAV Policy Team at Centre City Tower, 7 Hill Street, Birmingham, B5 4UA, or by email to NAVpolicy@ofwat.gsi.gov.uk

Representations must be received by Ofwat no later than 17.00 hours on 17 December 2018. Further information about how to make representations or objections, including information on the treatment of confidential information, can be obtained from Ofwat at the above address or at <http://www.ofwat.gov.uk/foi/>

Ofwat will only use the information you have provided for the purpose of this consultation. We will retain your information in accordance with Ofwat's retention schedule. We often publish responses to consultations when finalising policies, if you consider any information in your submission to be confidential please provide both a confidential and a non-confidential version. For further information please see Ofwat's Privacy Policy in our Publication Scheme.

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1. Overview

- 1.1 Our policy for NAVs was last updated in January 2014.¹ Following that update, we commissioned Frontier Economics to undertake a study of NAV activity.² That study, published in October 2017, identified a number of barriers to entry that were preventing NAVs from competing effectively. When we published the report, we committed to a number of actions to help NAVs compete on a level playing field.³
- 1.2 We also said that we would give further consideration to the strategic role that we anticipate NAVs will play in the sector in future years; the benefits that a successfully functioning NAV market could deliver to customers in terms of competitive diversity, efficiency and innovation; and the way that we regulate the sector to ensure an appropriate balance between facilitating and promoting effective competition and protecting customers.
- 1.3 This document sets out our views on these issues. It first outlines the issues raised by Frontier Economics in its assessment of NAV activity and sets out the changes we have made to address barriers to competition. We then go on to explain why we consider the vision for NAVs which underpinned the 2014 policy is still appropriate today. We recognise, however, that the market is still evolving, and we may need to review our approach in future. Finally we outline the changes we have made to update the 2014 policy document including to reflect the changes we have made to address barriers faced by NAVs.
- 1.4 Accompanying this is a [draft revised NAV Policy document](#).

¹ New appointments and variations – a statement of our policy <https://www.ofwat.gov.uk/wp-content/uploads/2017/09/Statement-of-NAV-policy.pdf>

² <https://www.ofwat.gov.uk/publication/study-nav-market-report-frontier-economics/>

³ <https://www.ofwat.gov.uk/publication/study-market-new-appointments-variations-summary-findings-next-steps/>

2. Background

Regulatory framework for NAVs

- 2.1 NAVs can compete with incumbents to supply infrastructure and retail services to new build development sites not served by, or with the consent of, the current incumbent. They can also compete to supply large users (customer taking more than 50MI/d in England, or more than 250MI/d in Wales).
- 2.2 NAVs can take on two broad forms:
- **Full-NAV** – A NAV can provide a complete end-to-end service. On the water side this incorporates obtaining a water source, treatment, distribution and retailing. On the wastewater side this incorporates collection, treatment and sludge treatment including disposal.
 - **Bulk-supply NAV** – A NAV can provide its own onsite infrastructure, but rely on a bulk supply of water, or bulk discharge of waste water, from or to the local incumbent's network. The NAV still serves end-customers, but the NAV pays the incumbent for bulk services.
- 2.3 Some NAVs may use a bulk-supply for one service (e.g. waste water) but have their own resources for the other.
- 2.4 NAVs have the same duties and responsibilities as the previous statutory water company. When companies apply for a licence, we check that the applicant has the ability and resources to meet its legal duties and responsibilities. The Drinking Water Inspectorate and Environment Agency also separately check the suitability of the applicant.
- 2.5 When we grant a license, we check that the customers of the company will be no worse off overall than they would have been had they been served by the incumbent. We also include a “relative price control” in the company's license so that the prices it can charge are linked to those of the local incumbent.

The barriers to NAVs and our responses

- 2.6 Frontier Economics identified a number of barriers relating to regulatory and administrative barriers; access to information and service standards from incumbents; pricing issues; and awareness. We have taken a number of

actions to address these issues. These barriers are summarised in the table below, together with the actions we have taken.

Regulatory and administrative barriers

Issue: Several respondents to the Frontier Economics report noted that the process for applying for a NAV limited the scope for competing for new development sites. In particular, there was uncertainty over whether a licence would be granted, and the time it takes precludes NAVs from competing for smaller sites.

Actions:

- We have provided [further guidance on “unserved” criterion](#) for applicants.
- We have clarified our approach to financial viability assessments in the [accompanying policy document](#) and the [application guidance](#).
- We have streamlined our [NAV application processes](#) to reduce the timeframe for applications from a target of 110 working days down to 85 days.
- Our [application guidance](#) also provides clearer information on our policies and processes to applicants.

Access to information, service standards

Issue: Access to information that is essential to be able to provide a commercial offering to developers was noted by many NAVs as being inadequate.

Actions:

- We have an ongoing program monitoring commitments from Water UK and incumbents to publish information to support self-service (eg identifying network connection points), to share best practice in improving services to NAVs and to undertake a review of how incumbents report on the level of service provided to NAVs.
- This includes challenging the industry to develop a Code of Practice for bulk supply/discharge agreements. If one is not reached by agreement we will consider imposing one.
- We have included the “D-MeX” outcome delivery incentive as part the PR19 methodology to incentivise incumbent companies to deliver a better service to NAVs, as well as developers and SLPs.
- We have consulted on a licence modification⁴ requiring companies not to discriminate between their own offerings and those of alternative providers (including in the provision of developer services).

⁴ <https://www.ofwat.gov.uk/consultation/consultation-under-section-13-of-the-water-industry-act-1991-on-proposed-modifications-to-the-licence-conditions-of-17-water-companies/>

Pricing issues

Issue: NAVs suggested that the way incumbents price bulk services and services to developers can prevent them from competing for some sites.

Action: We have issued new bulk supply charging guidance which changes the way bulk supply charges are to be determined to facilitate greater competition⁵. We have also concluded that incumbents should change the treatment of the income offset⁶ so that bulk-supply NAVs will benefit from it.⁷

Awareness

Issue: Several NAVs suggested that awareness of the option to use a NAV was low amongst developers. Some NAVs also noted that other agencies, specifically the Environment Agency and the Drinking Water Inspectorate, have less awareness of NAVs than they have of incumbents and this can make agreeing plans to serve sites more difficult.

Action: We have a program of providing information to raise awareness with developers and other agencies. Additional information has been provided on our website on the role NAVs play in serving developers. Ofwat representatives have attended developer events and highlighted the role of NAVs. And we have organised visits to NAV sites with other agencies so that they can learn directly about the benefits that NAVs can provide.

Longer term issues

2.7 In its assessment of NAV activity Frontier Economics also identified three long-term issues.

⁶ The income offset refers to the discount incumbents apply to site development costs intended to reflect future income from the site that reduces the charges developers pay for connections. Until April 2018, the income offset was regulated by section 43 of the WIA (which has now been repealed). It provided that the income offset calculation was made taking the infrastructure costs of a development less an amount to reflect the income the incumbent would receive from the site over a twelve year period. Since the repeal of section 43 WIA, the income offset is regulated by charging rules issued by Ofwat. In developing charging rules, we must have regard to guidance issued by Defra. Defra's most recent charging guidance specifies that the balance of contributions between developers and bill pays should be broadly maintained.

⁷ See <https://www.ofwat.gov.uk/wp-content/uploads/2017/07/New-connection-charges-for-the-future-England-1.pdf>. This introduces changes from April 2020. We have also introduced temporary arrangements pre-April 2020 through bulk supply agreements.

- 2.8 The first related to “cherry-picking”. This concern derived from the fact that NAVs are required to match local incumbents’ geographically averaged retail tariffs, but the cost of serving sites may vary geographically. NAVs may therefore have an incentive to serve low-cost sites, with the greatest margin, leaving incumbents to serve high-cost sites.
- 2.9 Frontier Economics did not identify any evidence suggesting this was a meaningful concern in practice. Nevertheless, it noted that using a “wholesale-minus” approach to setting NAV bulk supply charges would reduce any concern that NAVs might cherry-pick low cost to serve sites. This approach would base the bulk supply charge on the price of wholesale water charged to retailers and then deduct the cost of serving the sites. These deductions should vary based on the costs of serving the site.
- 2.10 Our revised bulk-supply charging guidance⁸ adopts this approach and consequently we consider this helps address any concern that NAVs might cherry-pick sites.
- 2.11 The second long-term issue Frontier Economics identified was linked to the opening of the business retail market. Several NAVs were concerned that they would have to offer business retailers with customers on their sites a price that matched the incumbents’ wholesale tariffs. However, this would leave insufficient margin, as the incumbents’ wholesale charge does include an allowance for the additional costs of last mile infrastructure needed to serve new developments.
- 2.12 We do not think this is a material concern. In setting wholesale charges, NAVs’ licences do not specify that they need to match the local incumbent’s wholesale charges. Rather, NAVs must follow our Wholesale Charging Rules⁹ which require, amongst other things, wholesale charges to reflect long-term costs.
- 2.13 The third issue Frontier Economics noted was the potential impact of upstream reform on NAVs. Specifically, it may, in future be possible for NAVs to acquire water resource or bioresource services from providers other than incumbents. Frontier Economics notes that this creates an opportunity for NAVs, which may

⁸ <https://www.ofwat.gov.uk/wp-content/uploads/2018/05/Bulk-charges-for-NAV-fnal-guidance.pdf>

⁹ <https://www.ofwat.gov.uk/wp-content/uploads/2016/11/Final-wholesale-charging-rules-and-Summary2.pdf>

help them compete more effectively. However, Frontier Economics also notes that the access price NAVs would have to pay to convey water/sewage across incumbents networks may need amending to take into account differences in costs across an incumbents area as we set out in our Water2020 consultation.¹⁰ Since those markets are yet to open we have not yet set out access pricing rules that would apply to NAVs.

¹⁰ https://www.ofwat.gov.uk/wp-content/uploads/2015/12/pap_tec20150525w2020app4.pdf

3. The Role of NAVs in the Water Sector

3.1 Our policy statement from 2014 set out the potential benefits NAVs could provide to the sector which include:

- lower prices;
- improved service;
- a better range of products and services;
- environmental benefits; and
- greater choice of supplier for developers and large user customers.

3.2 Frontier Economics identified four broad categories of benefits arising from NAV activity:¹¹

- better services and discounts on prices for developers and end-customers;
- economies of scope in particular developers value multi-utility offering as they only have to deal with one supplier;
- innovative solutions and efficiency such as water efficient sites that can help developers build out hard to serve sites as well as providing wider environmental benefits; and
- dynamic benefits which includes incentivising incumbent water companies to improve their service offerings to developers.

3.3 Frontier Economics noted that, given the limited scale of NAVs to date, the evidence was largely qualitative. However, its view is supported by our observations of the market. The discussions we have held with stakeholders following their report has confirmed these benefits are still relevant, though the evidence remains predominately qualitative.

3.4 The extent of these benefits may vary. At present, price discounts to end customers may be limited. A small number of NAVs discount their tariffs relative to the incumbents. But where they are applied discounts are typically represent a saving of around 5% and may be discontinued. This partly reflects that NAVs

¹¹ See section 3.4 of <https://www.ofwat.gov.uk/publication/study-nav-market-report-frontier-economics/>

are regulated through a relative price control – below we discuss the potential to regulate in a way that passes more cost through to consumers.

- 3.5 There may be greater benefits in NAVs reducing the time and cost of home building, and pushing incumbents to do likewise. This is supported by the experience of the energy industry where following a number of interventions to remove barriers, activity by new entrants increased considerably and accounts for between a fifth and half of all new connections.
- 3.6 However, in our view, the greatest benefits are likely to come through innovation, i.e. NAVs introducing new business models which increase operational and environmental resilience. These benefits may be more likely to arise from full-NAVAs because they have the greatest scope to adapt different approaches than the incumbent. By using alternative sources of water, installing water storage, introducing water reuse schemes and installing local waste treatment, full-NAVAs have the ability to increase overall network resilience, make sites cheaper and easier for developers to serve and test systems with the potential to for wider benefits if rolled out at more developments.
- 3.7 NAVAs may also provide benefits in other areas of the water supply chain. For example, there is potential to use information from NAVAs to challenge incumbent water companies' costs or performance. As NAVAs become larger this may become more feasible as information on their costs and performance may be comparable to that of incumbent water companies.
- 3.8 In addition, there may be further strategic benefits from NAVAs. For example, the opening of new markets may have the potential to increase the benefits that NAVAs bring to the sector. We have been told by some NAVAs that they are considering engaging in the bilateral water market (i.e. buying water directly from third parties) if Defra activates the legislation necessary for that market. They also have the potential to leverage their experience to engage in the bioresources and Direct Procurement for Customers (DPC) markets.¹²

¹² Direct Procurement for Customers refers to arrangements where incumbent water companies to open up to competition the provision (design, build fiancé and operate) of any scheme larger than £100m. It is discussed in <https://www.ofwat.gov.uk/publication/delivering-water-2020-final-methodology-2019-price-review-appendix-9-direct-procurement-customers/>. Our approach to

- 3.9 These benefits are important and in line with the priority areas highlighted in the English and Welsh Strategic Policy Statements (SPSs).^{13 14} Specifically, both SPSs stress the importance of innovation, resilience and environmental benefits. The benefits to home building are specifically mentioned in the English SPS.
- 3.10 We believe the actions we have already taken should allow NAVs to realise these benefits to a significantly greater extent. We are already seeing a significant increase in NAV activity, with more new entrants seeking licences and established NAVs seeking variations to serve more sites. Since 2016 we have granted 34 NAVs, which is almost as many as the number of NAVs granted since between 1997 and 2015 (fourty). We have a further 15 on-going applications, so the number of NAV sites is set to double in number since 2015.
- 3.11 We recognise that the evidence for these benefits is mostly qualitative and our expectations are as much based on principles and anticipation rather than direct evidence. But the increase in market activity may provide an opportunity for clearer evidence on the benefits of NAVs. We will therefore continue to monitor the market to see whether the benefits materialise as expected.

bioresources controls and markets is also set out in our Methodology statement
<https://www.ofwat.gov.uk/publication/delivering-water-2020-final-methodology-2019-price-review-appendix-6-bioresources-control/>

¹³ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/661803/sps-ofwat-2017.pdf

¹⁴ <http://www.assembly.wales/laid%20documents/gen-ld11283/gen-ld11283-e.pdf>

4. Changes to policy

Suggestions for further policy changes

- 4.1 We have reviewed our policies to consider how they can help bring about the benefits outlined above. We have held several meetings with NAVs and other industry members, such as CC Water, to discuss our policy, the changes we have made and whether any further changes are necessary.
- 4.2 In general, NAVs were positive about the changes we have already made, and believed that they would bring benefits to the market. However, they expressed disappointment with incumbents' progress on increasing access to information and service standards. We are also disappointed with industry progress in this respect and specifically on progress in developing an industry code of conduct. As noted in the table above, we said that if a code is not reached by agreement we would consider imposing one. If significant progress is not made by the end of 2018, we will begin work on developing a code ourselves.
- 4.3 Some NAVs also suggested further changes. Some of these suggestions appeared to be based on a lack of clarity about the current policy. For example, some NAVs raised questions about the ability to adapt tariffs to reflect quality differences which they thought would be prohibited by the no-worse-off principle we apply to NAVs. The no-worse-off principle does not prevent such changes, but does place the onus on NAVs to demonstrate that customers value quality differences sufficiently so that any difference in tariff does not make them worse off overall before we alter a NAV's licence to enable it to charge higher tariffs. We have updated our policy to clarify this point.
- 4.4 Some other issues raised by NAVs would require more substantial work across agencies, including Defra.
- 4.5 For example, one NAV has suggested that changes be adopted that either remove the income-offset, or compel incumbents to make a payment to full-NAV. They argued that the income offset, which acts as a discount to developers on the cost of developing a site, distorts competition as incumbents recover the remaining costs from its wider based of customers (via its price control). But NAVs have no existing, or a significantly smaller, customer base from which they can recover costs. Consequently, a greater increase in the customer bill is needed to recover sufficient revenue to cover the costs not recovered from developers. This means that the income off-set can act as a barrier to NAVs. Our guidance on NAV bulk charges sets out that NAVs that bulk supply

charges should pass on the income offset to NAVs (as developer charges do). But this does not benefit full-NAVAs as they do not make payments to the incumbent and so there is no charge to apply the income-offset to.

- 4.6 As we said in our decision on “[New connections charges for the future – England](#)”, we are not aware of a means by which we could compel incumbents to make a payment to full NAVAs as there is no trading relationship between the parties. We did, however, say we may revisit the role of the income offset altogether in future. This would require NAVAs and Ofwat to engage with Defra, as its guidance specifies that the balance of contributions between developers and bill pays should be broadly maintained.
- 4.7 NAVAs also noted that the national approach to licensing in the energy market made competing with incumbents easier. However, legislation in the energy sector is different and we would not be able to implement national licensing for NAVAs without alterations to primary legislation, as geographically defined licences, and the criteria for a NAV to be granted a new site, are specified in the Water Industry Act 1991. This work is outside Ofwat’s remit, and would require NAVAs to engage with other agencies. However, it is not clear that the barrier warrant such significant changes at this point in time.
- 4.8 The Consumer Council for Water raised the concern that end customers have seen only limited direct benefits from NAVAs. This partly reflects that NAVAs are regulated through a relative price control. Consumers do benefit from indirect benefits such as faster home-building, improvements to the environment and strategic benefits leading to a more efficient water market more generally. More in-depth regulation, such as a direct price control, could also increase direct benefits to customers. However, it would require significant input from NAVAs and us, increasing this costs of the regime, and potentially disincentivise NAVAs from growing. We therefore do not believe this is appropriate at present. But as NAVAs become larger it may be more appropriate to adopt alternative forms of regulation that seek to share cost benefits with NAV customers directly.

On-going monitoring

- 4.9 We will continue to monitor the impact of our existing commitments to see how the market develops. We will consider the extent to which incumbent water companies respond positively to the benefits that NAVAs bring, by embedding and supporting our regulatory reforms. If we consider that NAVAs continue to face barriers which prevent them from fully participating in the developer

service market we may take further action. We also expect NAVs to respond to these changes to increase the benefits that customers get from the regime, particularly by using innovative business models and demonstrate to us that they are doing so.

4.10 We will also keep under review the information we require NAVs to submit on an annual basis. All NAVs currently fall below the £10.2 million revenue threshold that defines what information companies provide and therefore they complete the two tables in the small company report, rather than the 44 tables in the report for companies with turnover greater than £10.2 million.

Proposed changes to policy document

4.11 All of the changes to our policy document are minor in nature and reflect how our approach to NAVs has adapted as their activity has grown. However, we have identified the areas that have been amended and invite interested parties to comment on. These changes are:

- We have updated the links to documents we have updated to reflect changes to our process guidance (July 2018) and bulk charging guidance (May 2018);
- We have amended links to reflect the changes to the DWI's policies towards NAVs;
- We explain that NAVs no longer need to submit their charging schemes to us each year for approval, but must publish these on line in accordance with our charging rules;
- We provide greater clarification on the application of the no worse off rule; and
- We have updated the text to reflect our revised approach to assessing financial viability of NAVs.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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November 2018

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