10 October 2017

Trust in water

Study of the market for new appointments and variations – summary of findings and next steps

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Contents

1. Background and purpose of this document

The New Appointments and Variations regime was introduced under the Water Industry Act 1991 (**WIA91**) to provide a mechanism to facilitate new entry into the water and wastewater sector and to allow appointed undertakers (incumbents) to expand outside of their geographical area of appointment.

Under section 7(4) of WIA91 Ofwat can appoint a company in place of the incumbent only where one of the following criteria is met:

- the incumbent agrees to transfer part of its area of appointment to a different company (a transfer by "**consent**");
- the area is "**unserved**" (it does not contain any premises that are served by an incumbent) or;
- the new appointment or variation only relates to an area where each of the premises are (or are likely to be) supplied with at least 50 megalitres of water a year (by an undertaker operating wholly or mainly in England) or 250 megalitres a year (by an undertaker operating wholly or mainly in Wales) and the relevant customer wants to change its suppliers (a "**large user**").

To date, the vast majority of new appointment variation applications have been granted under the unserved criterion and relate to the provision of water and/or wastewater services to new residential and mixed used developments.

When deciding how to provide connection services for a new development site, the developer can choose between the incumbent, a self-lay provider (**SLP**[1]) or a new appointment variation provider (**NAV**). If a NAV is appointed, it becomes the monopoly supplier for the site and generally provides, owns and operates the 'last-mile' on-site supply infrastructure and retail services. In most cases, however, it is reliant on a range of input services from incumbents, including a "bulk-supply" or "bulk discharge" delivered to/from the site boundary; network information; and sometimes network reinforcement in the incumbent's area to enable the site's connection.

[1] A developer can choose to "self-lay" the onsite infrastructure for a development site using an accredited contractor. The incumbent will subsequently take over responsibility for (adopt) the self-laid infrastructure.

The introduction of this form of competition "for the market" was seen as a means of harnessing market forces to provide a challenge to incumbents; drive efficiencies and stimulate innovation. In doing so, it was hoped that the market would deliver benefits for all customers through lower prices; improved service; environmental benefits, as well as offering greater choice of supplier for developers and large user customers.

However, while applications have increased, the scale of the market is still relatively modest[2]. Moreover, despite a number of changes to our NAV policies and processes, stakeholders have continued to express concerns about the extent to which the existing regime is fit for purpose. NAVs have also been telling us that they encounter various difficulties in entering the market and competing to provide water and/or wastewater services to new development sites.

In November 2016, we announced our intention to use our powers (under section 27 of WIA91) to review the NAV market. In December 2016, we commissioned Frontier Economics (**Frontier**), in association with Addleshaw Goddard, to undertake the review. In doing so, we asked them to:

- investigate how the NAV market is working;
- investigate whether there are any features of the market which may be having the effect of preventing, restricting or distorting competition; and
- set out options for addressing any issues or concerns identified - taking account of the extent to which current and planned initiatives and policy developments are capable of addressing these issues.

The report, which is attached as Appendix 1, identified a number of potential barriers that could impact on the ability of NAVs to compete on a level playing field with incumbents, and with SLPs, to serve sites.

We have considered the report's findings and how we might respond to them. There are a number of actions that the sector can take now or is already taking under our leadership to address these issues. These actions are set out in the following sections. In some instances, they will involve us undertaking follow-on work, engagement and consultation with stakeholders. In others, we will be looking to the sector to step-up and address the concerns identified by the Frontier report and its customers. We will monitor the sector's progress in meeting this challenge closely and will continue to engage with market participants to assess the extent to which these actions are helping to make the market work more effectively to deliver

[2] As of September 2017, 8 new appointees had entered the market; NAV licences had been granted for 69 sites, to serve approximately 61,000 residential customers once the development sites are completed.

benefits for customers. If we consider that the response is not sufficient, or if issues are not being addressed quickly enough, we may decide to take further action, using the full range of tools available to us.

While the main focus of the Frontier report was on investigating how the market is working and the extent to which its potential development is being impeded by the existence of barriers to competition, it also touched upon a number of other, longer-term issues and impacts that will require further consideration (e.g. concerns about cherry-picking and the impact on incumbent's cost base or the impact of upstream reform on the current NAV operating model).

In the coming months, we will be giving further consideration to the strategic role that NAVs 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.

2. Summary of review findings and next steps

The Frontier report highlighted a number of issues about the way the NAV market is working which could hamper the ability of NAVs to compete effectively with incumbents. These are summarised under three broad headings:

- **Regulatory policy and process barriers -** the regulatory and policy requirements and administrative processes around applying for a NAV licence;

- **Behavioural barriers** – the transparency, timeliness and effectiveness of incumbent water companies' provision of information and other inputs services needed by NAVs; and

- **Pricing** – the margin that NAVs are able to earn, including the underlying methodology of the incumbents' charges underpinning those margins, and whether there is a level playing field between NAVs, SLPs and incumbents.

These issues were seen by NAVs (and some developers) to present significant barriers to competition. Whilst incumbents were not dismissive of the concerns raised by NAVs, some felt that the scale of barriers was overstated. Some noted, for example, that barriers might be intrinsic to the economics of a NAV (i.e. some sites might be too small for a NAV to bid for) or that an incumbent's behaviour or approach to pricing might reflect their understanding of Ofwat's regulatory guidance or case law, rather than be a reflection of anti-competitive intent (for example a concern that if they offer a lower price to a NAV they might breach Licence Condition E, the requirement not to discriminate between customers).

In the following sections, we summarise the main concerns highlighted by the review and we set out our proposed actions to address them.

2.1 Regulatory, policy and process barriers

The review highlighted a number of areas where the current regulatory framework and our policies and processes may inhibit the ability of NAVs to enter the market and compete with incumbents on a level playing field. In particular, NAVs told Frontier that:

- "the criteria under which a new appointment or variation can be granted are limited and uncertain;"
- "the timescales involved in processing an application are too long"; and

- "the information and assessment requirements for granting a new appointment or variation are unnecessary and burdensome"

We respond to each of these issues below. It important to note that the circumstances in which we can grant a NAV licence are set out in legislation. In addition, when deciding whether to grant a particular new appointment or variation to an existing appointment, we must do so having regard to our various legal duties, including our duty to ensure that customers (including the existing appointee's customers) are protected.

In assessing NAV applications, therefore, we have an important balance to strike between enabling competition by removing any unnecessary barriers to competition and fulfilling our duties in protecting the interests of customers, both those of the potential NAV area and the existing customers of the incumbent company.

2.1.1 "the criteria under which a new appointment or variation can be granted are limited and uncertain"

We can only appoint a new water and/or wastewater company in place of an incumbent if the application satisfies one of the three criteria set out in legislation (i.e. the incumbent consents to transfer part of its area of appointment to the NAV; the area is unserved; or the supply is requested by a customer that qualifies as a large user).

To date, the vast majority of NAV applications have been granted under the unserved criterion. Ofwat has provided guidance for NAV applicants in New appointments and variations – a statement of our policy. However, it would appear that NAVs still consider that our requirements for demonstrating that a site qualifies under this criterion are uncertain and unnecessarily onerous. Some NAVs have suggested, for example, that the requirement to provide a site status report, produced by an independent professional adviser, to confirm that there are no existing water and/or wastewater services on a site, is unnecessary on sites where the development is clearly new, or where the incumbent has confirmed that the site is unserved. NAVs claim that this requirement results in them incurring costs that incumbents do not face, leads to increased risk and uncertainty, and causes potential delays to the application process. NAVs suggested that in some instances, these risks may result in the developer defaulting to the incumbent or choosing to use an SLP to provide the site's infrastructure, rather than choosing a NAV.

Our response

The criteria for granting a NAV licence are set out in WIA91 and any adjustments would require a change in legislation and are a matter for Government rather than ourselves.

We have reviewed our policies and processes for assessing NAV applications on a number of occasions. In doing so, we have sought to provide greater clarity for stakeholders and have consulted with them in updating our approach[3].

Nevertheless, we note the review's findings that there remain some areas where further guidance or clarification could help remove unnecessary uncertainty and associated risks for applicants. **We will review our existing guidance to determine what further information or clarification we can provide to applicants in coming months.**

We will also consider how we might improve the way in which we communicate information on our existing policies and processes to ensure that these are consistently applied. This could include, for example, further clarification on the circumstances in which an independent report may be necessary or the alternative ways in which a prospective NAV can demonstrate to us that a site is not served. It may also include guidance to incumbents on how we expect them to respond to a NAV seeking confirmation that a site is unserved.

We will also review our internal processes to ensure that our policy is being applied consistently for all applications under the unserved criterion. This will also help to reduce the need for follow-on queries, reduce the timeframe taken to complete the assessment processes and reduce the uncertainty that NAVs believe exists at the present time.

2.1.2 "the timescales involved in processing an application (both statutory time limits and time taken in practice) are too long".

The Frontier report found that some NAVs had concerns about the length of time it can take for Ofwat to assess an application and reach a decision to grant a licence. It also noted that the process can be uncertain and susceptible to delay. Some NAVs

[3] In addition to our statement of policy, we have also issued New appointment and variation applications - the terms of reference for independent professional advisers providing site status. This guidance sets out the information that we typically need to assess whether a site qualifies as unserved, how to deal with those sites where there are served properties within the boundaries of the proposed new NAV site, and also details how a previously served site can become unserved.

felt that, as a result, the timescales involved were incompatible with the shorter timeframes a developer has for smaller development sites (i.e. the majority of development sites) and that this can result in a developer defaulting to the incumbent water company or using a SLP.

Our response

In New appointments and variations applications – a statement of our process we indicate that we expect the application process to take up to 110 working days from submission of the application to us. This includes the minimum 28 calendar day public consultation period, which is a legislative requirement.

The process may take less time in very straightforward applications, but can take longer if:

- the information provided in support of the application is incomplete;
- we require clarification or more information from an applicant;
- the application raises new or complex issues; or
- concerns are raised by respondents during the public consultation.

We also note that applicants can assist us to reduce the time we take to process their applications by:

- being familiar with our policy and process;
- providing sufficient information of high quality and a high degree of clarity as part of their application to enable us to conduct our assessment;
- proactively providing us with any updated information relevant to their application;
- providing the Environment Agency (**EA**) and the Drinking Water Inspectorate (**DWI**) with sufficient information of high quality and clarity; and
- discussing with us any points of policy or process where applications lack clarity.

Our current policy and process statements already provide a significant amount of information and guidance to applicants on the information that we need to enable us to assess their applications. Moreover, our ability to alter the process significantly is constrained by the need to meet the requirements set out in legislation.

Nevertheless, we note the feedback from stakeholders and **we will review our processes, and engage with stakeholders, to see if there are ways in which these can be improved further**.

We will also consider whether we can **provide better, clearer information on our website to accelerate the application process** and avoid situations where we need to request more information or further clarification before progressing an application. This could include, for example, **the use of standard templates** which applicants could use to submit information to support their application and help to reduce the length of time taken to complete the assessment process and grant a licence. We will also ensure that we **communicate where we have "stopped the clock"** on processing an application because we are waiting for required information from the applicant.

2.1.3 "the information and assessment requirements for granting a new appointment or variation are unnecessary and burdensome"

A number of NAVs have suggested to us and to Frontier that our financial viability and 'no worse off' assessments on a site-by-site basis create an unnecessarily onerous burden for applicants.

Some NAVs have suggested that the assessment process could be streamlined to reduce the regulatory burden on applicants and avoid situations where applicants are providing the same information for successive site applications. It has been suggested that for established NAVs we could:

- adopt a portfolio approach when assessing the financial viability of applications from NAVs with multiple sites;
- allow companies to submit annual returns to demonstrate how their service levels compare with incumbents in whose area they are applying for a licence, rather than requiring them to submit this information for every additional site they apply to serve; or
- allow NAVs to provide annual statements of assurance to avoid having to submit the same/similar information to support every new application and reduce the time taken to submit and process the application.

Our response

As indicated above, when assessing a NAV application, we have a statutory duty to ensure that the applicant has both the ability and the resources to meet its legal duties and responsibilities and will deliver acceptable standards of service to the customers it has applied to serve.

Nevertheless, **we will review our current assessment processes and consider whether there are ways in which these can be streamlined to reduce the burden on applicants. We will engage with stakeholders to inform our review, and consult as appropriate.**

2.1.4 Other regulatory barriers

The Frontier review also highlighted a perceived lack of understanding on the part of other regulatory bodies about the role of NAVs and the way in which they are regulated by Ofwat. Some NAVs suggested that this lack of understanding could impact on the way in which the EA and DWI view them and could result in their proposals to serve a site being subjected to greater scrutiny or being seen to be more "risky" than if the site was served by an incumbent. In addition, some NAVs told Frontier that, in their view, the EA's approach to abstraction licensing and discharge consents could prohibit entry by NAVs that sought different solutions to water supply and wastewater disposal from traditional ways. The report also noted, however, that these concerns were discussed with the EA during the course of the review and whilst the EA is aware that some NAVs have these concerns, it is keen to encourage innovative approaches.

Our response

We will discuss the findings of the Frontier report with the EA and DWI to determine what, if any, additional information would make it easier for them to carry-out their function in relation to NAV applications.

2.2 Behavioural barriers - information and service level issues

The review also identified a potential for behavioural barriers resulting from the relationship between incumbents and NAVs and, in particular, NAVs' reliance on incumbents for a range of input services, that only the incumbent can provide (i.e. they are non-contestable), to be able to deliver their own business.

These services are required for various aspects of, and at various points during, the NAV application process. These include, for example, inputs to enable the NAV to determine its network design and costs and assess the viability of serving a site; to agree bulk supply conditions; to provide inputs to Ofwat's financial viability assessment to support the licence application; and to deliver network reinforcement in the incumbent's area where needed. Developers who are exploring options for serving a new site will also wish to be aware that they have a choice in who provides

their new infrastructure and have some clarity on respective offers. As noted in the report, this can sometimes be at the time of land acquisition (and as part of deciding whether to proceed with acquisition), and before and after planning applications.

A key issue reported by NAVs was the difficulties they can face in obtaining key information from incumbents, in particular a) timely and transparent information for connections and offsite reinforcement works (both technical specification and costing detail), and b) bulk supply offers. This can restrict their ability to assess the viability of serving a site and producing a costed offer for a developer. It can also lengthen the time taken to reach the point at which the NAV can submit an application to Ofwat and hence delay the overall process.

Some NAVs also claimed that the way in which incumbents arrive at their cost estimates (e.g. for modelling or for network reinforcements) can be unclear and they have little means of checking whether incumbents are being reasonable or even-handed compared with the service they provide to SLPs or when serving developers directly themselves. This lack of transparency can also result in lost time for the NAV in having to seek clarifications on costing before they can quote to a developer.

Similar experiences were reported in relation to negotiating a bulk supply price and concluding a bulk supply agreement. Negotiating individual bulk supply agreements was described as being time consuming and unnecessary.

NAVs also told Frontier that the input service they receive from incumbents can vary significantly between incumbent companies, both in terms of timeframes and quality of service. While some incumbents have defined levels of service for responding to a NAV on its connection enquiries or other input services sought (and have adopted policies and processes to ensure equivalence with SLPs and their own in-house provision), it was reported that delivery is inconsistent across the sector.

The lack of guaranteed timeframes for the provision of information and other input services for NAVs can risk lengthening the process involved for a developer to secure the new infrastructure it needs, relative to a developer using the incumbent. As a result, NAVs claimed that developers often ‘default’ to the incumbent to provide the service or opt to use an SLP as an intermediate option.

Our response

Incumbents need to actively manage their obligations under competition law, in particular where their competitors rely on non-contestable services that

only the incumbent can provide[4]. Incumbents have a responsibility to provide the input services in a transparent, timely and objective way to all parties, whether they are a developer, a SLP or a NAV, and should ensure that all parties are treated equivalently to their own in-house developer services provision.

Incumbents should consider how they can demonstrate to their customers that they are ensuring a level playing field for the new connections market in order to improve trust and confidence in this area.[5]

While some incumbents have been making efforts to improve their service delivery to NAVs (and our charging rules for new connections will also help to driver greater transparency and reduce complexity and potential delays in this area), improvements have not been seen across all companies. More needs to be done to provide greater certainty regarding the levels of service NAVs receive.

In line with our strategy Trust in Water and our approach to regulation, we will give the sector an opportunity to step-up and take action to address these concerns before we use our formal regulatory tools. Water UK has written to us on behalf of customers[6], setting out the steps that incumbents will take to address the concerns raised by NAVs with a commitment to deliver a number of these steps by April 2018. They note, in particular, that:

- work is being undertaken by Water UK's Self-Serve Group to encourage incumbents to **publish information to support self-service** by enabling NAVs and others to access information on points of connection and connection charging for standard work. They are also exploring how the self-

[4] In March 2017, we published updated guidance on our approach to the application of competition law in the water and waste water sector. In that guidance (page 28) we reminded incumbents (as dominant undertakings) that they have a special responsibility not to allow their conduct to impair or distort competition. We also noted that a dominant company is not absolved of this special responsibility as a result of the existence of sectoral regulation.

[5] Following an Ofwat investigation, Bristol Water (BRL), for example, put in place a series of commitments to provide greater assurance that it is providing its non-contestable services on an equivalent basis to SLPs and its own developer services business. Amongst other things this included changing its organisations structure and processes to demonstrate a clearer distinction between its wholesale and retail functions and the contestable and non-contestable services it provides. This enabled it to better recognise SLPs as customers of BRL's non-contestable services, and as BRL's competitors for contestable services. It also provides greater transparency to BRL's SLPs customers that they are being treated fairly and on a level playing field.

[6] A number of incumbents have also been engaging with us to inform us of the steps that they are taking to ensure transparent and equivalent processes for the provision of services to NAVs. These include commitments on service delivery.

serve model could be enhanced further by providing new information platforms, data or processes to enhance the level of convenience for NAVs and other customers;

- the implementation of Ofwat's rules on new connection charging will help to reduce the need for upfront customer-facing modelling and, from April 2018, will mean that customers will be able to establish a reasonable estimate for standard work using information that is publically available. This will also help to ensure a level playing field as NAVs, developers and SLPs will have access to the same information; will be able to calculate the incumbent's charge for their own preferred solution and any other standard solution which has been defined by another participant and; will also allow NAVs to monitor the extent to which the incumbent's charging regime provides them with fair and equivalent charges;

- the incumbents propose to use Water UK's Infrastructure Policy Group as a forum to exchange information on how to improve services to NAVs, to document best practice and facilitate a programme of lessons learned. They see this as dovetailing with their work on new connections charges and aim for it to be concluded by April 2018; and

- they are planning to conduct a fundamental review of the way in which incumbents report on their levels of service to customers. This will link to the work that they are doing in response to Ofwat's proposals on the introduction of a new developer services experience incentive mechanism **(D-Mex)**

As part of our consultation on our PR19 methodology, we have proposed introducing the D-Mex as **a means of** incentivising companies to deliver a better overall service to a wider range of customers – including services to NAVs. Taking into account responses from the consultation, **we will be publishing our decision statement on the PR19 methodology in December 2017**.

We will monitor the implementation of the measures proposed by Water UK between now and April 2018.

We will consider the merits of introducing a **statutory code of practice for of bulk supply/discharge agreements**. There are provisions in the Water Act 2014

(**WA14**)[7] which would enable us to do this, though these provisions have yet to be commenced by either the UK Government or Welsh Government.

If we fail to see significant progress with sector-led initiatives, we will consider whether we need to take further action – using the full range of our regulatory and competition tools[8].

2.3 Pricing barriers

Pricing issues were highlighted as a key area of concern for NAVs. In particular, it was noted that the margin a NAV is able to earn can be significantly distorted by a) the current charging arrangements for new connections (set out in WIA91) which provide discounts to developers (known as an income offset) when a developer requests an incumbent to provide its new infrastructure, and b) the incumbents' approaches to bulk supply pricing. These are considered separately below.

2.3.1 New connection charges – the treatment of income-offset

The review noted that in certain circumstances, incumbents are able to offer developers a larger discount than a NAV can by offsetting the expected income from customers on the site[9] against the costs of both the contestable onsite works (that the NAV is competing for) and any non-contestable works that only the incumbent can do to reinforce the existing network in its area. While this is consistent with the current legislation, it can have the effect of distorting competition in favour of incumbents[10].

[7] Sections 8 and 9 of WA14 amend sections 40 and 110 of WIA91 and introduces a new section 40(B) and 110(C) to enable us to issue one or more codes in respect of bulk supply/discharge agreements.
[8] Ofwat also has concurrent powers with the Competition and Markets Authority (**CMA**) to apply competition law with respect to water and wastewater activities in England and Wales. Given our focus on realising the benefits of effective competition for water and sewerage customers, our concurrent powers under competition law are a critical part of our toolkit for intervening when markets are not performing or delivering as they should.
[9] If the onsite work is undertaken by a SLP and subsequently adopted by the incumbent, the incumbent makes an "asset payment" on a similar basis.
[10] As noted in the Frontier report, for example, if the expected income from customers on the site (the income offset) is larger than the entire onsite cost, this would cover not only the onsite cost but could also be set against some of the offsite cost. However, if the site in question is to be served by a NAV, the NAV would not be able to provide the additional discount on the offsite costs. This could tilt the playing field in favour of the incumbent.

Our response

The Water Act 2014 repeals the statutory provisions that deal with income offset and instead gives Ofwat the power to make charging rules on new connections. These changes have allowed us to introduce a much more flexible charging framework for new connections.

In December 2016, following consultation with the sector, we published charging rules for new connections. These will come into force on 1 April 2018[11].

These rules state that the costs of all offsite work should be recovered by means of an infrastructure charge and that the costs of onsite (contestable) work should be recovered by means of a requisition charge. In addition, the rules also introduced changes in the treatment of the income offset to ensure that incumbents will no longer be able to offset the expected future income from customers on a site against the costs of both the contestable onsite works and non-contestable off-site reinforcement works to connect the site.

In our December 2016 decision document, we said that the expected income from customers on the site should be netted off the requisition charge. We also said that we would consider the issue in more detail and consult further with the industry.

We issued a further consultation on New connection charges for the future - England in July 2017 and proposed changes to the way the income offset (and asset payments to SLPs) should be treated. This is aimed at ensuring a level playing field and address concern that, in some instances, NAV do not receive equivalent treatment (i.e. no income offset is paid to them). In particular, we proposed that asset payments are eliminated and that the income offset is paid to all (SLPs and NAV) by netting it off against the infrastructure charge instead of the requisition charge. This, we consider, would help to ensure a level playing field for new connections services and improve transparency and would mean that every new connection (whether provided by an incumbent, SLP or NAV) would receive an income offset and be treated equally.

We are currently considering the responses to the July consultation document and expect to publish a summary of the responses received, and the details of any further changes to the charging rules, in the Autumn.

[11] These rules only apply to companies whose areas are wholly or mainly in England. Ofwat will set new charging rules for Wales when the Welsh Government has put in place its guidance to allow this to happen. The existing charging arrangements in WIA91 will continue to be applied until they are replaced.

2.3.2 Bulk supply charges

Most NAVs are reliant on a bulk supply of water from (or a bulk discharge of wastewater to) an incumbent. As noted in the Frontier report, the margin a NAV is able to achieve is largely derived from two prices, both of which are set by the incumbent: a) the water/wastewater end customer price (a ceiling amount a NAV can charge end customers in its area due to our "no worse off" relative price regulation) and b) the bulk supply/discharge charge.

The terms of the bulk supply agreement, including the price, are subject to commercial negotiation between the parties, but the parties can ask us to intervene and reach a determination if they fail to reach an agreement, or are in dispute over the terms of that agreement. In the past, we have issued a number of documents to assist companies in reaching an agreement and in providing guidance on the approach that we would use if required to intervene in a dispute and determine the price of the bulk supply. In this guidance, we have suggested that the parties could use the relevant large user tariff (**LUT**) as a basis for negotiations where the NAV's forecast demand qualifies. We also noted that any costs that the incumbent will incur, or not incur, as a result of the NAV serving the site could then be added, or deducted, from the bulk price.

NAVs suggest that whilst most incumbents have set bulk supply charges based on their LUT or a standard wholesale charge, on the whole, these charges make no allowance for the "last-mile infrastructure" costs that NAVs incur and, as a result, NAVs are placed at a significant competitive disadvantage when bidding for sites – particularly for small and medium sized development sites.

The NAVs interviewed by Frontier stated that the current approach to setting bulk supply charges by many incumbents renders any development site below the size of approximately 500 properties economically unviable.

Our response

After engagement with stakeholders and the concerns raised by NAVs during the course of the Frontier review, **we are planning to consult on a new approach to bulk supply charges in the Autumn**. The guidance will consider how to approach all future determination requests related to the charges in a bulk agreement between an incumbent water company and a NAV.

2.4 Other barriers

Beyond the three key areas of concern, the Frontier report also considered a number of other potential barriers to competition in the NAV market, in particular a) economies of scale requirement preventing some types of NAV developments from succeeding, and b) lack of information by developers about NAVs was preventing NAVs from growing their business.

2.4.1 Economies of scale requirement

Some incumbents suggested that the reason that NAVs seem to be restricted to large sites could be due to the existence of economies of scale. Incumbents provided no evidence to support this view and NAVs refuted this claim.

Frontier found little evidence of the existence of economies of scale in terms of building the **last-mile local infrastructure**, citing the extent of entry by SLPs which has already been seen in the new connections market.

Similarly, whilst Frontier noted that economies of scale could potentially be a factor in the **provision of retail services**, they also noted that many of the existing NAVs were companies that already provided retail services in other sectors (e.g. energy) so were set up at a scale and would not, therefore, explain why these NAVs are not winning smaller sites.

Finally, Frontier noted that even if scale was a factor in determining the viability of a company deciding to enter the NAV market (e.g. because of the costs of setting up and operating a business), this would not affect the ability of those NAVs already present in the market to compete for new sites or explain why NAVs might be restricted to large sites.

2.4.2 Information barriers

Frontier also highlighted a number of "information barriers" that stakeholders claim are inhibiting the development of the market. The report noted, for example, that many developers are not aware of the option of choosing a NAV rather than the incumbent or faced difficulties in accessing information on the choices available to them.

Our response

The evidence in the Frontier report has not made a case, at this point, for the existence of barriers to entry to the NAV model through existence of economies of scale. We will keep this issue under review.

The Frontier report set out a number of ways in which developers could be made aware of the option of using a NAV to provide water and/or wastewater services to a site or to ensure that NAVs are given an opportunity to compete for a site (e.g. requiring the incumbent to provide the developer with a list of NAVs or to inform NAVs of contacts from developers). **We will review the information we provide on our website to make it easier for developers to understand the options available to them**. We will also **engage with the Home Builders Federation and House Builders Association to discuss what further information their members might find useful and the steps that could be taken to build awareness within the sector**.

2.5 Next Steps

The main aim of the Frontier review was to identify potential barriers to competition in the NAV market. In the previous sections we set out the steps that we, and the sector, are taking, or are proposing to take, to address those barriers and respond to the specific concerns raised by NAVs and other stakeholders. These actions are summarised in the following table and we will be engaging with stakeholders and the sector on these steps in the coming months.

Issue	Next steps
Regulatory and administrative barriers	• We will review our existing guidance for applications under the "unserved criterion" to determine what further information or clarification we can provide to applicants. • We will provide further clarification on the circumstances in which an independent report may be necessary or the alternative ways in which an applicant can demonstrate to us that a site is not served. • We will review the way in which we communicate information on our existing policies and processes to ensure that these are clearly and consistency understood and applied. • We will review our internal processes to ensure that our policy is being applied and communicated consistently for all applications under the unserved criterion. • We will review our current assessment processes and consider ways in which these can be streamlined to reduce the burden on applicants. • We will provide better, clearer information on our website to accelerate the application process (e.g. the use of standard templates).

	• We will ensure that we communicate where we have "stopped the clock" on processing an application because we are waiting for required information from the applicant.
Access to information, service standards	• We will remind incumbents of the need to be aware of, and actively manage, their obligations under competition law, in particular where their competitors rely on non-contestable services that only the incumbent can provide. • We will challenge incumbents to improve levels of service for NAVs and consider how they can transparently demonstrate to their customers that they are ensuring a level playing field. • We will monitor the implementation of the measures proposed by Water UK between now and April 2018. • We will discuss with them how improvements in levels of service to NAVs can be captured and reported to ensure greater transparency. • We are considering responses to proposals on the use of D-MeX to incentivise companies to deliver a better service to customers, including NAVs and we will be publishing our decision statement on the PR19 methodology in December 2017. • We will consider the merits of introducing a statutory code of practice for bulk supply/discharge agreements.
Pricing issues	• We are currently considering the responses to the July consultation on charging rules for new connections and expect to publish a summary of the responses received, and the details of any further changes to the charging rules, in the Autumn. • We are planning to consult on a new approach to bulk supply charges in the Autumn.
Awareness	• We will review the information we provide on our website to make it easier for developers to understand the options available to them. • We will also engage with the Home Builders Federation and House Builders Association to discuss what further information their members might find useful and the steps that could be taken to build awareness within the sector. • We will discuss the findings of the Frontier report with the EA and DWI to determine what, if any, additional information would make it easier for them to carry-out their function in relation to NAV applications.

The Frontier report also highlighted a number of other issues and longer term impacts in relation to the development of the NAV market within the wider sector. We will consider these issues further. They include:

- **Impact of de-averaging -** concerns that by lowering barriers, a thriving NAV market could lead to cheaper to serve sites being "cherry-picked" by NAVs. If incumbents are left with more expensive sites, this could increase their average cost base and, ultimately, lead to an increase in prices for end customers.

- **Impact of retail market opening -** with business retail market opening (and potential residential retail market opening), NAVs have to offer wholesale tariffs to retailers. As NAVs in turn rely on a bulk supply from incumbents), there are concerns about how they account for their own last mile infrastructure costs to avoid squeezing retailers.

- **Incentives on incumbents –** the report also highlighted suggestions from some incumbents about the lack of an incentive to operate out of region. This, they claimed, was due to the form of the current price control and the fact that under the PR14 wholesale revenue cap, when an incumbent loses a new development site (initially forecast in the business plan) there is no adjustment to the allowed revenue through the regulatory control. This could mean that the lost revenue is still recovered, but spread out over existing customers. However, proposed changes to the form of the wholesale controls at PR19 will make companies' revenues more responsive to changes in levels of development that they undertake.

- **Impact of upstream reform -** the introduction of competition for water resources and sludge treatment could introduce new opportunities for NAVs to engage in those markets and could bring changes to the current NAV operating model, including the way they are charged for upstream services, their access to the incumbent's distribution network, and the way in which they charge for providing access to their infrastructure.

In coming months we will be giving further consideration to a) the strategic role that we anticipate NAVs to play in the sector in future years; b) the benefits that a successfully functioning NAV market could deliver to customers in terms of competitive diversity, efficiency and innovation; and c) the way that we regulate the sector to ensure an appropriate balance between facilitating and promoting effective competition and protecting customers.