Albion Water Limited
Response to Ofwat's consultation on bulk supply and bulk discharge charges to NAVs
8 January 2018

Q1 Do you agree with our assessment on the need for this supplementary guidance?

That the uptake of NAVs has not been realised as anticipated supports the need for change in many areas. The biggest cost to any NAV that is not operating on a full-service basis will be the bulk supply and/or bulk discharge charge from the incumbent.

In negotiating a bulk supply, all of the power is concentrated in the incumbent. The NAV's only recourse is through a determination, as stated in the consultation. However, this is not in practice a realistic option as the determination process is difficult, disproportionately costly and risky (for the NAV) and may take a long time. NAVs are generally in competition with the incumbent, especially on new housing developments, and any indication of added complexity will result in the developer withdrawing from discussions with NAVs; they already see the process as long, slow and complicated.

Whilst incumbents state that published wholesale tariffs represent a starting point for negotiations, in practice they represent the end point as well. As a result margins are essentially set in stone.

As is recognised in the consultation, many of the current margins available to NAVs do not adequately reflect the costs of operation and ownership between the point of connection and the consumer. This is particularly the case at lower volumes (generally below 1,000 properties). Whilst the standing charges essentially cover metering and billing, there are cases where the operating margin is actually negative.

The consultation indicates that NAVs make margins in two areas: "*building the on-site infrastructure for the developers*" and "*services provided to end-customers*". In the vast majority of cases all of the NAVs margins come from end-customers. NAVs do not have any particular economic power in the delivery of on-site infrastructure: they contract with third-party installers in exactly the same way as developers do, as indeed do many incumbents.

This means that the only accessible margin is between bulk and end customer prices. We therefore agree with the need for supplementary guidance.

Q2 Do you agree with the purpose, scope and objectives for our proposed guidance?

Notwithstanding the above, overall for Albion Water this consultation only covers one issue in relation to competition. It relates only to bulk supply / bulk discharge NAVs – whilst a fair charge is important it is fundamentally just about dividing up the same "pie". Much more important, and not addressed by this consultation, is the ongoing un-level playing field between incumbents / bulk supply / bulk discharge NAVs on one side and NAVs looking to offer a full service (or part thereof – e.g. recycled water) on the other. It is the full service NAV which has the potential to add real value to the end customer, developer and the environment by taking a fundamentally different approach to the provision of water supply and waste water services. Albion Water made these points to Ofwat in the NAV review, and in the consultation on income offsets / asset payments, however none of the changes made to date address this issue.

Albion Water will be writing to Ofwat shortly with more detail about how the market for full service NAVs can be improved. Gareth King (Albion Water) and Mathew Stalker (Ofwat) have been liaising over setting up a meeting at our Rissington NAV site where we are taking this full service approach. I think a date is still be to confirmed but this would be an excellent opportunity to discuss this issue further.

Q3 Do you agree with our assessment of the options and our provisional conclusion in favour of a wholesale-minus approach?

In general we agree with the assessment. However we are very disappointed that the examples would indicate that a NAV would be prepared to compete on a zero margin basis as shown in Table 1. Even as an indicative example of the benefits of a wholesale-minus approach, it gives an entirely skewed perception of the economic intentions of NAVs. Albion Water believes that it should be able to use its skills and abilities to deliver services more cost-effectively than the incumbent, but the intention is very much to make a positive return.

The starting point should be for NAVs to be offered the same avoided cost base as the incumbent would have had within the appointed area. To the extent the NAV can then deliver local services at reduced cost it should benefit from these savings. Albion Water has a track record of sharing savings with consumers.

The wholesale-minus approach is the only way for clear, transparent, benefits to flow through. Any cost-plus exercise on any complex system has too many opportunities for allocation and apportionment. This has been evidenced time and again in Ofwat documentation: incumbents do not have clear, detailed, marginal cost information at the scale relevant to NAV sites. The margin of error (accuracy) of the cost base being apportioned is far lower than the potential on-site costs.

Accordingly, we believe that transparency can only be delivered on a wholesale-minus approach.

Q4 Do you agree with our considerations in terms of whose cost should be used in a wholesale-minus approach? Do you have a preference? If so, please specify the reasons for your preference.

Whilst we agree with the statements regarding the benefits of using the incumbent water companies' costs, there are three problems with this approach.

Firstly, as stated above, incumbents simply do not maintain records at a sufficiently fine detail for the majority of NAV-scale developments. Therefore, there are too many opportunities for allocation and apportionment to erode the cost base, with margins being cut.

Secondly, where this applies to new developments, there is no established cost base to be assessed. This leaves the option to consider more a generic, or even artificially low, cost base, again eroding potential margins.

Thirdly, some of the relevant costs will be associated with aspects which are not core services offered by incumbents, such as the provision of on-site non-potable water.

Where there are clear costs in an area being considered for a NAV then it may be possible to use existing costs. This could apply to existing industrial sites or where a new development, building on a discrete but existing operation, is proposed. However, these would need to be established by an independent, open audit subject to challenge, to avoid the issues identified above.

Overall, therefore, we believe that costs should be based on efficient benchmarks, but this needs clear definition. This is covered later.

Q5 Do you agree with our proposed overall approach for setting bulk charges?

We agree with the proposed approach, but more detail is required on the costs by which the wholesale tariff is reduced. This is discussed further in the subsequent questions.

Q6 Do you agree with our proposed relevant starting point?

In setting a starting point, whilst due care does indeed need to be taken of the relative dynamics of domestic and industrial customers, this should not be allowed to introduce unnecessary complexity into the process.

Experience has shown us that the main segments in which NAVs operate are usually either "pure" industrial or "pure" new housing developments. The likelihood of a NAV being sought for a true "mixed development" is extremely small, so it is suggested that the starting point should be entirely based upon either domestic- or industrial-based tariffs. Only if it can clearly be demonstrated that more than a diminimus proportion of volume (maybe ~20%) is split, then the weighted average approach should used.

Albion Water believes that the biggest untapped opportunities for NAVs relate to new housing developments. Almost by definition these exclude large industrial customers. The dynamics of the small number of associated commercial premises (shops, offices, small industrial units) are far closer in nature to domestic than industrial operations. Further, the impact of the non-domestic aspects of new developments may not reasonably be known at the outset as they are often only agreed in outline at the point a NAV would be sought. As a result the inclusion of this additional complexity is unnecessary in most cases.

The currently-published wholesale tariffs have already been derived to reflect these two differing positions, with what are already deemed to be appropriate retail margins reflecting the limited risks associated with customer service and billing (but NOT the supply risks).

Q7 Do you agree with our definition and approach to estimate the ongoing on-site costs?

We agree with the broad approach to on-site costs. In particular, it is important to ensure that there has been appropriate consideration of all relevant costs impacting on the bulk supply (or discharge).

As a minimum there should be allowances for operating and maintenance costs including managing leakage, repair, testing and meter replacement as well as any associated regulatory or reporting requirements.

There should also be recognition that with a NAV the incumbent's income will be higher than if it supplied the end customers. To mitigate for this, firstly there should be recognition of the reduced bad debt provision that the incumbent will make, as not only does the debt liability transfer to the NAV but the NAV is required to provide security which, in the event of being triggered, covers any potential bad debt from the NAV to the incumbent. Secondly, unless corrected for, the incumbent will obtain higher income as a result of on-site leakage being chargeable to the NAV at the bulk supply rate (assuming a bulk meter is required) – whilst if the incumbent were operating the site then no revenue would be obtained from the water that leaks. In both cases fixed adjustments should be applied to the wholesale tariff so that the incentive to manage bad debt and leakage remains with the operator, i.e. the NAV.

Crucially a further reduction should be applied where the approach taken by the NAV provides wholesale benefits to the incumbent.

The most obvious example of this is where the NAV has invested to reliably reduce demand. By reliably we mean the provision of a dedicated non-potable water system for toilet flushing and garden watering as opposed to measures where there is a real risk that demand reductions are not sustained in the medium to long term: fittings can be replaced, power showers installed and rainwater systems fall into disrepair through lack of maintenance.

The delivery of these solutions comes at a price which is not recognised by the incumbent. The initial installation is essentially subsidised by the developer and the operating risks then pass to Albion Water but the benefits of lower consumption pass to the incumbent water company.

Wholesale prices are, by necessity, fixed despite the marginal cost of delivery varying greatly across regions. For new developments it is almost always the case that the marginal cost of supply will be greater than average. Further, the marginal cost increases as greater capacity is needed: by definition the last megalitre per day of capacity will always be more expensive than the first megalitre per day. When Albion Water installs a non-potable network this reduces the peak and average demand and therefore the required water resources and distribution capacity to serve the site. In addition the reduced demand means that the incumbent can make greater use of their lower cost sources of water than would otherwise be the case.

The incumbent therefore gains a benefit at the expense of Albion Water, the developers and, ultimately, consumers. In the latter case consumers invariably gain a further economic benefit from non-potable supplies, which are priced at a discount to deliver appropriate economic signals to customers.

We therefore propose that the capital and operating costs of running any assets associated with sustainable demand reduction (particularly dedicated non-potable infrastructure) also be treated as costs to be deducted from the wholesale price.

Q8 Do you agree with our discussion about the WACC? In particular do you think we should adjust the incumbent water company's WACC as per the Priors Hall determination?

Incumbents are in a special financial position which results in their WACC being lower than a NAV could achieve, therefore a WACC adjustment is appropriate to ensure that the NAVs costs are recognised.

Q9 Do you have any practical suggestions on how to estimate the appropriate WACC?

It is proposed that the WACC is set midway between a benchmark incumbent WACC and a benchmark NAV WACC.

Q10 Are there other costs that we should take into account? If so, please specify what these costs are and why they should be considered.

See question 7.

Q11 Do you consider that the proposed approach is sufficiently flexible to cover all current circumstances and could adapt to possible future changes?

Albion Water hopes that the regulatory regime around NAVs will change substantially in the future, particularly to ensure a level playing field between incumbents and full service NAVs (see Question 2). Any approach therefore needs to be flexible enough to cope with what might be substantial changes.

Q12 Do you consider that it would be possible to standardise charges under many if not most circumstances? Can you specify the circumstances where this may not be possible?

Costs should be as standardised as possible but relate to the site specific infrastructure. A good starting point could be an approach similar to what water companies need to have in place by 1 April for "self serve" cost estimating for on site infrastructure. This recognises that some sites may contain infrastructure that needs to be assessed, and priced, on a site specific basis.

Q12 (sic) Do you agree with our proposal for the provision of tariff information?

No comment