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Bulk charges for NAVs: a consultation

This letter and associated appendix provides our response to Ofwat's bulk charges for NAVs consultation.

We support the development of markets in the water sector, where they deliver long-term benefits for customers. We also welcome the conclusion of Ofwat's study of the NAV market, and we were pleased to see the approaches we have adopted to support our NAV customers being recognised as good practice.

In recent years, we have undertaken a number of initiatives to support the development of the NAV market (e.g. committed levels of service). We have sought to ensure all participants in the market for new water infrastructure are able to compete on an equivalent basis.

We have undertaken significant work on access prices¹ for wholesale services and we are keen to support Ofwat in developing the detailed arrangements in due course, consistent with the requirements of the Competition Act 1998 (CA98).

We agree that a wholesale-minus approach should be the basis for charging. We believe the aim should be to ensure efficient entry can be facilitated, for the benefit of customers.

Our view is that known, company costs are the most appropriate basis for the minus element. If a hypothetical benchmark is used, it should be based

¹ https://www.anglianwater.co.uk/assets/media/Access_Pricing_-_Issues_paper_-_Main_report_-_FINAL.PDF



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on an equally efficient operator rather than a reasonably efficient operator. We do not agree with the suggestion that the costs to be deducted should be set at such a high level that inefficient entry is encouraged (which we feel would not benefit customers).

We trust these comments are helpful as you develop the guidance. Please do not hesitate to get in contact if you wish to explore anything further. Arun Pontin (aPontin@anglianwater.co.uk 07973 965537) would be a good point of contact in the first instance.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Alex Plant'.

Alex Plant
Regulation Director

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Question 1: Do you agree with our assessment on the need for this supplementary guidance?

We agree that there is a case for supplementary guidance on charging for NAVs. Greater clarity could help participation and improve market outcomes. There have been a number of developments in this market in recent years, including various guidance documents from Ofwat, the outcome of the market study and the outcome of previous determinations under sections 40, 40A 110 and 100A of the Water Industry Act 1991. To avoid confusion, and to aid market participants, consolidation of this previous material would be beneficial.

Question 2: Do you agree with the purpose, scope and objectives for our proposed guidance?

We agree that the purpose, scope and objectives of the guidance should be to support a level playing field between potential NAVs and incumbents.

We presume the guidance would acknowledge the need for consistency with CA98 and other obligations placed on companies.

Question 3: Do you agree with our assessment of the options and our provisional conclusion in favour of a wholesale-minus approach?

Yes. We believe that in principle, a wholesale-minus approach is the best way to achieve the stated objectives. This aligns to the conclusion of our work on access pricing², published in the market place for ideas, that minus based approaches are a reasonable way of setting prices.

Question 4: 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.

We think that the choice between incumbents' own costs and a 'reasonably efficient benchmark' is somewhat theoretical, since companies have evidence to support an estimate of the former but not necessarily the latter.

We believe using the incumbent companies' own costs is preferable. It is difficult to comment on the appropriateness of the hypothetical benchmark without sight of the methodology which would be used to set it.

² [https://www.anglianwater.co.uk/assets/media/Access_Pricing - Issues_paper - Main report - FINAL.PDF](https://www.anglianwater.co.uk/assets/media/Access_Pricing_-_Issues_paper_-_Main_report_-_FINAL.PDF)

The use of a hypothetical benchmark could introduce national averaging to the 'minus' element of the charge. This would encourage inefficient entry in regions where the incumbent is more efficient than the benchmark and exclude efficient entry in regions where the incumbent is less efficient than the benchmark. If incumbent's costs are used and in fact, it turned out that these were too high because the incumbent was inefficient then the NAV would benefit and the incumbent would be rightly penalised for its inefficiency.

If a hypothetical benchmark is used, we believe it should be based on an equally efficient operator rather than a reasonably efficient operator. We do not agree with the suggestion that the costs to be deducted should be set at such a high level that inefficient entry is encouraged. Our review of the evidence from other sectors and relevant Competition investigations under Article 102 TFEU suggests that no pricing regime should promote entry at all costs. To do so would harm the long-term interests of consumers.

In particular, we do not agree with the notion that allowing higher cost firms to enter in the short term is worthwhile in the longer term when economies of scale and scope can be achieved. Achieving these efficiencies is uncertain, in the short term there would not be lower costs to the developer and these are unlikely to materialise in reduced charges for end users in the longer term as once the site is built there are limited competitive pressures on NAVs. As such we do not think that the case has been made that promoting inefficient entry in the short term is in the long-term interests of customers.

Using an equally efficient operator as the basis for a benchmark ensures the market is not foreclosed to efficient entrants without promoting inefficient entry to the detriment of customers. A recent precedent in this area is Ofcom's use of an adjusted equally efficient operator benchmark to regulate the margin between BT's wholesale and retail superfast broadband services.

Question 5: Do you agree with our proposed overall approach for setting bulk charges?

We agree with the overall approach, subject to the detailed arrangements being finalised.

Question 6: Do you agree with the proposed relevant starting point?

Yes, we agree in principle. It is worth noting, however, that a way would have to be found to deal with the fact that the contracting parties would not know in advance each year what the exact mix of properties and volumes

was going to be. There may be incentives on parties to attempt to optimise their charges when entering negotiations. This could be addressed in a number of ways in the terms and conditions of the prices to be published.

Question 7: Do you agree with our definition and approach to estimate the ongoing on-site costs?

We agree with the definition of on-site ongoing costs. As explained in our response to question four, we believe that the cost of the incumbent company should be used.

Question 8: 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?

Question 9: Do you have any practical suggestions on how to estimate the appropriate WACC?

We have given thought to whether the required rate of return for a new housing development could be expected to be significantly different from the general WACC that is allowed by the regulator at price reviews. We conclude that there is no evidence that indicates that the two would be very different. Accordingly we believe that the prevailing allowed regulatory WACC would be the appropriate return to use in these circumstances.

As a technical matter, we believe that the cost of capital of a project is a function of the intrinsic characteristics of a project, not a function of the circumstances of the entity that is notionally seeking to raise the finance. Consequently, we think that any effect on a WACC brought about by 'regulatory protections' are separate to consideration of that 'project cost of capital'.

It is also worth pointing out that the importance of the issue may, in fact, be quite modest in any event. Given the expectation that the 'income offset' may be transferred from the requisition charge to the infrastructure charge, in the normal course a NAV would not be expected to have invested in any assets itself because the developer would have provided them (or paid for them in full). With no 'up-front' investment on which a return needs to be assumed, the question of the right WACC is of little or no significance.

Question 10: Are there other costs that we should take into account? If so, please specify what these costs are and why they should be considered.

Generally, we believe that Ofwat has captured and discussed the relevant categories of cost but we note that the detail of how these costs are determined and treated is still to be developed. We would note that

appropriate allowances for 'on-costs' and overheads should be factored into the calculation.

Question 11: Do you consider that the proposed approach is sufficiently flexible to cover all current circumstances and could adapt to possible future changes?

Yes. Ofwat would be able to amend the guidance if necessary.

Question 12: 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?

We take standardisation to mean a situation where we publish a pricing structure or formula that gave NAVs the ability to work out what the bulk supply cost to them was going to be on any particular site quickly and easily, for example once they have input the expected number and type of properties together with projected volumes. If so, we believe that standardisation would be possible.

Question 13: Do you agree with our proposal for the provision of tariff information?

Yes, we agree in principle that the relevant pricing information should be published. However, companies should be given a reasonable period of time after the guidance is finalised before they are expected to publish the first set of standardised pricing formulae. The appropriateness of the provision of certain information will depend on the final form of the guidance.