

9 November 2017

Trust in water

Bulk charges for NAVs: a consultation

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About this document

Water companies¹ can offer ‘bulk supplies’ of water, receive ‘bulk discharges’ of waste water or both (we referred these together as ‘bulk services’) from other water companies.

Water companies can draw up a contract between them that sets out the terms and conditions of supply of bulk services (we termed these ‘bulk agreements’), including the price. Bulk services can be categorised as being:

- between an incumbent² water company and another incumbent water company; or
- between an incumbent water company and a company with ‘New Appointments and Variations’ (NAV³).

If water companies fail to agree on the terms of their bulk agreement, including the charges, they can ask us to make a decision (a ‘determination’) about what the terms and conditions should be.

Stakeholders have raised concerns both directly and during a separate review of the operation of the NAV market that the current bulk charges fail, in certain cases, to create a level playing field for NAVs.

This document consults on draft guidance to supplement the [bulk supply pricing principles](#) we published in 2011. We would use our proposed approach when

¹ In this document, we use the term ‘water company’ to refer to a company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991.

² In this document we use the term “incumbent water company” to refer to a water company for whom we directly set individual price controls. Although sizes vary, an incumbent water company will normally be significantly larger than a NAV. We also set price controls for NAVs, though these are set indirectly via the ‘no-worse-off’ principle. According to the latter, the tariffs set by a NAV cannot make customers worse-off than if they were supplied by the relevant incumbent water company. All incumbent water companies have their own water resources and treatment facilities.

³ All new companies must apply to us to be licensed to replace another appointed company in a specific area (a ‘new appointment’). Appointed companies must also apply to us to change their licence if they wish to extend the area that they service (a ‘variation’). In this document we use the term “NAV” to refer to a water company that has replaced, or will replace, one or more incumbent water companies in relation to specific sites and for whom we do not currently set individual price controls.

determining **bulk charges set by an incumbent water company for bulk services provided to a NAVs** in **England and Wales**.

This document needs to be read in the context of the relevant provisions of the Water Industry Act 1991 and, in particular, the relevant statutory duties that will apply to Ofwat when we make a relevant determination.

Responding to this consultation

We welcome your responses to this document by **08 January 2018**.

You can email your response to charging@ofwat.gsi.gov.uk. You can also submit your response by post to:

Charging
Ofwat
21 Bloomsbury Street
London
WC1B 3HF

Information provided in response to this document, including personal information, may be published or disclosed in accordance with access to information legislation primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1988 and the Environment Information Regulations 2004.

If you would like the information you have provided to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' with which public authorities must comply and which deals, among other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system or a blanket request for confidentiality will not, in itself, be regarded as binding on Ofwat.

Contents

1. Background	4
2. Why issue more guidance?	15
3. Our approach	17
4. Our proposed guidance	25
5. Next Steps	34
Appendix – Glossary	35

1. Background

In this section, we discuss the background to our proposed guidance:

- our current policy towards the NAV market;
- the NAV market today;
- the link between bulk services and the NAV market;
- developers' services;
- our legal powers;
- overview of our previous guidance; and
- recent developments.

Our policy towards the NAV market

The NAV regime in England and Wales provides a mechanism to facilitate new entry into the sector and to allow those already present to expand into other geographic areas. The introduction of this form of competition “for” the market was intended to challenge incumbent water companies, drive efficiencies and stimulate innovation. It was hoped that it would benefit developers and end-customers through lower prices, better quality of services, innovative and environmentally friendly solutions and more choice.

Under the existing legislation, we can appoint a new water company for a site (for water supplies, waste water services or both), if one of three qualifying criteria is met:

- i) **unserved** - the site is not connected to the water and/or sewerage infrastructure of the incumbent water company;
- ii) **consent** - the incumbent water company consents to the application; or

- iii) **large user** - each premise in the site uses at least 50MI in any year and the customer of each premise consents; the threshold is 250MI for end-customers of water companies whose areas are wholly or mainly in Wales.

Most NAV sites to date have been under the 'unserved' criterion and relate to new residential and mixed use developments. While in this document we discuss bulk charges in relation to new developments (i.e. unserved sites), this guidance would apply also to sites for which the incumbent water company has given consent and large users. Equally, for ease of exposition, although we often only refer to water services, this guidance also applies to waste water services.

A new development requires the roll-out of on-site infrastructure which needs to be connected to the incumbent water company's existing water and/or waste water mains. A developer can do this work itself or sub-contract it to a third party. The latter could be the incumbent water company, a Self-Lay Organisation (SLO⁴) or a NAV. If the developer chooses a NAV, it not only builds the on-site infrastructure, but also provides some services to the end-user customers on the site. These can include retail, other on-site services and in some rare instances also water and waste water services. NAVs therefore compete to provide services to:

- **developers**. NAVs compete with incumbent water companies, SLOs and developers to provide services such as building the on-site infrastructure to connect new dwellings to an existing water and waste water network; and
- **end-customers**. NAVs also compete with incumbent water companies for the operation and maintenance of these on-site assets and in some rare cases also for the provision of water and/or waste water services. This is a form of competition for the market to provide services to end-customers.

This form of competition helps to deliver our strategy of ensuring trust and confidence in the provision of water and waste water services, by delivering the following potential benefits:

- **developers** get more choice in the provision of on-site infrastructure, potentially allowing them to benefit directly from **cheaper connections, faster connections** and **better quality**, and sometimes, **better tailored services**. NAVs frequently offer a multi-utility service, potentially making development

⁴ Developers can choose to use a SLO to install or 'self-lay' new water mains and/or service connections.

easier and reducing administrative costs, by dealing with a single provider, rather than several utility companies.

If NAVs offer lower retail prices and better services to end-customers, as discussed below, developers could benefit too, as they will be able to sell a more valuable product to home buyers.

- **end-customers**, such as households and businesses, may benefit from **lower charges**. Under the no-worse-off principle, NAVs must at least match the incumbent water company's charges as a condition of their licence, but they often offer initial discounted charges to end-customers. The latter may also benefit from **better services**, for example, better retail or more efficient and environmentally friendly services.
- **innovation** which can benefit **end-customers**, **developers** and **incumbent water companies**. For example, this can take place through innovative environmentally friendly services/solutions that lead to lower water consumption and less production of waste water, lower cost ways of developing infrastructure and savings in the provision of multi-utility infrastructure. These could include, for example, Sustainable Urban Drainage Solutions (SUDS). All end-customers benefit from innovations that preserve or improve the environment.

The NAV market today

There are currently 8 NAVs operating 70 sites, serving around 60,000 residential customers and 700 business customers in England.⁵ This compares to around 58 million⁶ residential and business water and waste water end-customers in England and Wales. Most NAVs operate a 'bulk services' model, i.e. buying wholesale water and waste water services from the incumbent water company, delivered to the site boundary, and then providing the on-site infrastructure and retail services. Just two

⁵ Source: [Register of new appointments and variations granted to date](#).

⁶ Data is sourced from our cost assessment information request and accounts for the population served in 2016/17.

NAVs currently provide a 'full service', including water treatment services, or discharge services for waste water.⁷

While applications have increased in recent years, the scale of participation by NAVs is still small. Despite changes to our NAV policy and processes, stakeholders still express concerns about the regime or features of the market that may not create a level playing field. We understand that the proportion of new developments built and operated by NAVs is very small when compared to that provided by equivalent third parties in gas and electricity. In the provision of gas services about half of all connections are undertaken by independent third party operators, which are equivalent to NAVs.⁸

Frontier Economics' review of the NAV market

In December 2016, we commissioned Frontier Economics (FE) to:

- investigate how the NAV market is working;
- consider the extent to which any factors currently act to prevent, distort or restrict effective competition; and
- set out options that we might consider to address issues identified.

This was prompted by complaints from NAVs about the impediments they faced in providing services to developers and end-customers, creating an unlevel playing field. One factor was the incumbent water companies' bulk charges.

The FE review drew on published data and extensive stakeholder engagement. FE submitted a final report in May 2017 and we have been considering how to address the issues raised, including those regarding bulk charges. FE's analysis confirmed the importance of bulk charges as a factor affecting NAVs' ability to compete to provide services related to new developments.

We have now published the [FE review](#) together with our [summary of findings and next steps](#). NAVs suggested that whilst most incumbent water companies have set bulk supply charges based on their Large User Tariff (LUT) or a standard wholesale

⁷ Source: Ofwat data based on information received from NAV applicants.

⁸ See Ofgem's [webpage on Independent Gas Transporters](#).

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 FE stated that the current approach to setting bulk supply charges by many incumbent water companies renders the majority of development sites economically unviable.

In publishing the FE report and our summary of next steps, we noted that we were planning to consult on updating our guidance on bulk supply charges in the autumn and indicated that this would consider how to approach all future determination requests related to the charges in a bulk agreement between an incumbent water company and a NAV. Today, we have published this consultation document.

More broadly, when we published our [summary of findings and next steps](#), we mentioned that in the coming months we would 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. This consultation should also be seen in that context.

The link between bulk supplies and the NAV market

There are two types of bulk services:

- **Bulk services between one incumbent water company and another.**

These are often referred to as ‘water trades’ and often consist of transfers of large volumes of water. For example, the providing company might expand one of its existing water resources to provide a large volume of water to supply the receiving company’s customers.

To encourage water trading in our draft PR19 methodology we [proposed to maintain the water trading incentives from PR14](#), both export and import, for new water trades agreed in 2020-25. To qualify for the incentive, the water company would have to show that its trade complies with an Ofwat [approved trading and procurement code](#). This code ensures that only economically and environmentally beneficial trades will receive an incentive payment.

- **Bulk services from an incumbent water company to a NAV.** These usually involve the trading of relatively small volumes of water or waste water between a water incumbent and a NAV. For example, a NAV might supply a new housing estate using a bulk supply of potable water from an incumbent water company.

This proposed guidance only applies to the latter type of bulk service. Bulk charges are a critical part of a bulk agreement. This is because bulk charges influence the on-going margin and, therefore, whether a NAV can compete to offer water and waste water services to a site. For the most common type of NAV, its overall margin depends on the:

- **on-site development margin** – the one-off margin they make on building the on-site infrastructure for the developers; and
- **margin on the services provided to end-customers** – this on-going margin is determined by:
 - **end-customer prices** - these are capped by the “no worse off” principle, i.e. they cannot charge end-customers more than the incumbent water company would charge;
 - **bulk charges** – this is the charge for the bulk services in the bulk agreement; and
 - **on-going costs** – these are the costs of providing the on-site services and retailing costs.

Some (full service) NAVs also compete with incumbent water companies for other services. For example, they may have access to their own water resources and may treat their own waste water. These NAVs are less reliant on bulk services from incumbent water companies.

Our legal powers

Our role in determining the terms of bulk supply agreements is limited to situations where the parties are unable to reach an agreement. In general, we expect water companies to negotiate bulk supply agreements themselves without our intervention.

However, the parties may fail to agree on:

- the terms of a proposed bulk supply agreement;
- how the terms of an existing agreement should be changed; or
- whether an existing agreement should end.

These disputes can therefore be about prices, duration or other terms of supply. When parties fail to agree they can ask us to determine the terms of the bulk supply. We can determine the contractual terms of actual or proposed bulk supply agreements if certain conditions are met (see sections 40, 40A, 110A and 110B of the WIA91⁹). We can only make these determinations if we are satisfied that the various parties cannot reach agreement. Before we make a determination we must also decide that the proposal or, where appropriate, the variation or termination of the existing agreement¹⁰ is necessary or expedient:

- in the case of a bulk supply of water, to secure the efficient use of water resources or the efficient supply of water; or
- in the case of a bulk discharge of waste water, for the purposes of Part 4 (Sewerage Services) of the WIA91.

Ofwat also has concurrent powers with the Competition and Markets Authority (CMA) to apply competition law with respect to water and waste water activities in England and Wales. Where appropriate, we can use our competition law powers in relation to existing markets for bulk supplies to ensure they are working for the

⁹ Please note that sections 8 and 9 of the Water Act 2014 will make changes to the WIA91 that are not yet in force for all purposes. In particular (and see further below):

- section 8 of the Water Act 2014 will in the future substitute new sections 40 and 40A for those currently in the WIA91; and
- section 9 has (to date) only substituted a new 110A, and inserted a completely new section 110B, in relation to relevant agreements between incumbent water companies whose areas are wholly or mainly in England.

¹⁰ Until the changes made by section 9 of the Water Act 2014 are brought into force for this purpose we do not, unless we determined the terms of the original agreement, yet have the power to determine disputes about the terms of bulk discharge agreements involving at least one incumbent water company whose area is wholly or mainly in Wales.

benefit of all customers. We have published [guidance](#) on our approach to the application of competition law. Decisions on whether to open or continue investigations under the Competition Act 1998 (CA98) and whether and what enforcement action we should take under the CA98 will be made using our [prioritisation principles](#).

Interactions with charging rules

Changes to be made to the WIA91 by the Water Act 2014 can empower us to issue charging rules in relation to bulk agreements.¹¹ It is for Defra and the Welsh Government to decide when to bring those powers into force. The Water Act 2014 also amends the WIA91 to give the Secretary of State and the Welsh Government the power to issue guidance to us about the principles to be applied by us in determining the provisions of charging rules and as to the content of charging rules.

Defra issued [charging guidance](#) in January 2016. This set out Defra's four objectives for charges:

- fairness and affordability;
- environmental protection;
- stability and predictability; and
- transparency and customer-focused service.

The Welsh Government has consulted on [draft supplementary guidance](#). This provides detailed guidance related to bulk charges. It indicates that Welsh Government consider the environment and resilience as particularly important considerations.

In developing the final version of this guidance we will have regard to the guidance from both DEFRA and the Welsh Government.

¹¹ Section 40E of the WIA91 (to be inserted by section 8 of the Water Act 2014) in relation to bulk supplies of water and section 110F of the WIA91 (to be inserted by section 9 of the Water Act 2014) in relation to bulk discharges of waste water.

Overview of our existing guidance

Bulk supply pricing – a statement of our policy principles

In July 2011, we published '[Bulk supply pricing – a statement of our policy principles](#)'. Our 2011 pricing guidance covers both types of bulk supplies, so it does not apply solely on the bulk charges offered to NAVs.

The document set out the principles we use when making determinations on bulk supply agreements. These principles were intended to provide us with a clear basis for making decisions on individual agreements and provide stakeholders with greater clarity on how we reach our decisions. We also set out the types of information that we would likely need from relevant parties when making a determination.

In our 2011 pricing guidance, we said we would determine bulk charges so that those prices:

- reflect the costs reasonably associated with the provision of the relevant services;
- facilitate the efficient use of resources and effective competition, where appropriate; and
- are consistent with the discharge of the relevant duties and obligations of the relevant supplier.

Our 2011 pricing guidance also provides guidance on:

- the relevant services; and
- assessing the costs reasonably associated with the provision of the relevant services.

Negotiating bulk supplies – a framework

In August 2013, we published '[Negotiating bulk supplies – a framework](#)' for incumbent water companies as they consider negotiating suitable bulk supply agreements. We provided a checklist of 14 areas a bulk supply agreement could

cover. This guidance was separate to our 2011 pricing guidance. Pricing was not the main focus of this document, although it did discuss:

- the **price terms** which could be included in a bulk supply agreement, such as the structure of charges and the kinds of ancillary charges that could be covered; and
- **how prices could be adjusted**, e.g. by inflation, volume or periodically review.

Online guidance related to NAVs

Our [website](#) includes further guidance for NAVs regarding the negotiation of bulk supplies. This was drafted before, and not updated since, the introduction of competition in the retail business market in England in April 2017. We said that a NAV may often share the same cost characteristics as a large user from the relevant incumbent water company's point of view, such as:

- the delivery of a large amount of water to a single point of supply;
- one customer to manage; and
- no use of the local distribution network.

Therefore, we considered it was sensible for parties to use the relevant LUT as a basis for negotiations¹² where the NAV's forecast demand qualifies. Any costs that the relevant incumbent water company would incur or not incur as a result of the NAV serving the site should be added or deducted respectively from the bulk price.

However, we also noted that other approaches have been successfully used. For example, in previous negotiations, offers by incumbent water companies have included tariffs based on:

- the relevant full standard volumetric tariff; and
- a retail-minus approach to costs.

¹² We also state this in our '[New Appointments and variations – a statement of our policy](#)'.

Recent developments

We are aware that some incumbent water companies are currently in discussion with some NAVs to set specific standardised bulk supply tariffs.

2. Why issue more guidance?

In this section, we explain:

- the current concerns with competition in developers' services; and
- why we think there is need for more guidance.

Current concerns with competition in developers' services

We have identified the following potential concerns with respect to the current pricing of bulk services:

- **efficient entry** – incumbent water companies' current bulk charges may lead to inefficient entry decisions. In particular, they may provide insufficient margins for efficient NAVs to enter, especially on smaller sites. Conversely, in a few types of sites they may provide NAVs with margins that are too large. These margins may or may not be passed on to end-consumers; and
- **limited entry by NAVs** – the limited presence of NAVs might suggest that, among other factors, current bulk charges may not be conducive to a level playing field.

Incumbent water companies are vertically integrated. We consider that they have both the ability and the incentive to put NAVs at a disadvantage by setting high bulk charges. They have the ability because in the large majority of cases NAVs can only rely on the local incumbent water company for bulk supplies.¹³ Although bulk supply services are included in our revenue caps, there is room for incumbent water companies to flex their prices within this framework. This is because we set total revenue controls (rather than cap the level of each of their charges) and incumbent water companies have flexibility in setting their relative charges as long as the restriction of the revenue cap is met and charging rules abided by.

¹³ In some very rare cases a NAV may have access to its own water resources or could obtain them from another incumbent water company if sufficiently close to the border between two incumbent water companies. This would give them some choice over the supplier of bulk supply services. However, in the large majority of cases a NAV can only rely on the local incumbent water company.

Incumbent water companies not only have the ability to put NAVs at a disadvantage, but they also have the incentive to (i) discourage NAVs from bidding for developers' services that the incumbent water companies might be interested to bid for by setting higher than efficient bulk charges, or (ii) extract NAVs' higher cost efficiencies when NAVs are successful.

NAVs, both via direct engagement and during the course of our wider review of the NAV market, argued that the playing field was currently not level. Among other things, they expressed concerns about bulk supply charges which made it difficult for them to compete with incumbent water companies and SLOs for new development sites.

The need for more guidance

We consider there is the need for more guidance, because:

- there is evidence there are **issues with competition in developers' services**;
- **stakeholders have raised concerns** about current bulk charges; and
- the **new markets and forms of control** that will be introduced as part of PR19 impact on the information available to set charges and on the charges set by NAVs.

These points are discussed in more detail earlier in the document. Our view is that the market is not delivering the best outcome for developers or end-customers, nor providing appropriate incentives for innovation that would benefit end customers.

Questions

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

3. Our approach

In this section, we discuss our proposed approach for this guidance, in particular its:

- purpose;
- scope;
- objectives; and
- assessment of options.

Purpose

This document sets out our proposed approach to future determination requests related to the charges in a bulk agreement between an incumbent water company and a NAV. The aim is to create a level playing field in the provision of developers' services and the provision of water services to the end-customers in new developments.

Of the concerns raised by NAVs, as discussed above, bulk charges seem a key factor, as they represent a large part of NAVs' overall costs of providing services to end-customers. As discussed in Section 2, creating a level playing field could bring significant benefits to both developers and end-customers.

The proposed guidance in this document is only concerned with disputes which we deal with using our determination powers under the WIA91. It does not constitute guidance on the application of competition law. Incumbent water companies remain separately responsible for managing their own compliance with competition law. For example, incumbent water companies which have a dominant position must ensure that their actions do not constitute an abuse of dominance. Of particular relevance in this context are exclusionary behaviours, for example, setting prices which could be considered to lead to a margin squeeze.

Scope

We would apply our final guidance to any dispute about bulk charges between an incumbent water company and a NAV using our powers under the WIA91. The scope of disputes which can be referred to us includes charges for any range of bulk services required by NAVs to provide their services to their end-customers.

The scope of the bulk services that a NAV requires may cover both water and waste water or, depending on the needs of the NAV, only a subset of these services. For example, some NAVs may not require waste water bulk services in whole or in part, because they might treat their end-customers' waste water themselves and, where possible, recycle it for uses that do not require potable water (e.g. toilet flushing). Distinct waste water networks could collect grey water separately from black water. The former would be reusable as non-potable water. NAVs may also capture all of their surface water through a SUDS, partially reducing the demand for waste water bulk services.

Alternatively, some NAVs may decide to rely on water resources, either treated or untreated, from providers other than the local incumbent water company. If the new development is sufficiently large, in the future NAVs may also self-supply water treatment services. Furthermore, some NAVs may have their own proprietary water resources and not require treated bulk water from the local incumbent water company. As technology evolves, the range of services required by NAVs may also change over time.

NAVs must be free to choose which services they wish to purchase from the local incumbent water company. Therefore, bulk charges should be flexible and relate solely to the services a NAV requests from the incumbent water company. This is particularly important going forward, as ongoing reforms in opening up markets in England will provide more opportunities for NAVs to source services from providers other than the water incumbent.

Our objectives

We aim to produce guidance that helps to deliver our strategy of ensuring trust and confidence in the sector by:

- providing a level playing field between incumbent water companies, SLOs, developers and NAVs;
- ensuring that, as far as possible, the increased choice for developers leads to more intense competition and the benefits are passed on to both developers and end-customers in the form of lower prices, better quality services and more innovation;
- encouraging the adoption of innovation that also benefits the environment;
- being simple to apply by providing: (i) incumbent water companies with sufficiently detailed guidance to set their charges at the appropriate level to reduce the risk of triggering a request for determination; and (ii) NAVs with the confidence that they have sufficient and timely information on which to bid for developers' work;
- being sufficiently flexible to cater for differences in the types of sites and the types of services required by NAVs; and
- being sufficiently general and flexible to make it reasonably future-proof - this proposed guidance should remain broadly relevant, applicable and easy to interpret, even if a range of unexpected market and regulatory developments took place.

Option assessment

We have considered some broad options as to what the most appropriate approach would be for this guidance. We first examine whether a cost-plus or wholesale-minus approach would be more appropriate in this context. Second, we consider whose costs should be used if we opted for a wholesale-minus approach.

Cost-plus vs. wholesale-minus

There are two main approaches to setting bulk charges.

A **cost-plus approach** aims at estimating the efficient costs of all service elements purchased by a third party, including an appropriate margin. For bulk services this would entail the incumbent water company estimating the efficient incremental costs

of supplying, for example, treated water up to the boundary between its network and the on-site network of the NAV.

A **wholesale-minus** is an alternative to a cost-plus approach. It starts with the incumbent water company's wholesale tariff(s) and deducts all the costs of the services (including an appropriate margin) that the incumbent water company would no longer provide. We have termed these costs 'relevant costs' and in Section 4 we explain more precisely what these consist of.

We have examined the high level pros and cons of the two approaches in terms of how they perform in terms of:

- **efficient on-site entry** - i.e. the approach ensures that efficient entrants have an incentive to compete for developer's services;¹⁴
- **productive efficiency** – i.e. the approach provides incentives to minimise the costs of provision to customers; and
- **risk of errors** - i.e. the approach minimises the risk of us making errors in a determination.

Taken together we consider these criteria, if met, would lead to good results for developers and end-customers.

A cost-plus approach provides strong incentives for the incumbent to become more efficient in the provision on non-contestable elements of the service – i.e. the provision of bulk water to the boundary of a new development. At the same time, it allows competitors to challenge the incumbent for the contestable elements of the service – i.e. the services NAVs provide such as retail services and the ongoing costs of operating and maintaining the on-site assets. A cost-plus approach is often applied to similar situations in other regulated utilities. For example, access charges in the telecommunications sector are often set on the basis of the forward-looking Long Run Incremental Cost (LRIC) of an efficient hypothetical operator. This aims at achieving productive efficiencies in the provision of these non-contestable services, while at the same time promoting competition in the contestable services. However, we consider that a cost-plus approach to set bulk supply charges in water raises

¹⁴ By efficient entry we mean entry that brings benefits both in terms of static efficiency (i.e. cheaper ways to provide services and cheaper prices for developers and/or end-customers) and dynamic efficiency (i.e. new services or increased competition). See also discussion in the section "Implementing the wholesale-minus approach" below.

concerns, due to the geographic average nature of retail and wholesale tariffs in the water sector. Our concern is that a cost-plus approach could lead to inefficient **entry incentives** for NAVs.

The illustrative example in Table 1 shows how geographically averaged charges can affect a NAV's entry incentives under both a cost-plus and wholesale-minus approach. It assumes that there are two new developments with an equal number of residential premises and equal overall water consumption. In addition, the location of the sites is such that the cost of supplying bulk water to the boundary of the two sites is also identical. However, we assume that Development 1 has low site-specific relevant costs (say, a high rise building), while Developer 2 has high site-specific relevant costs (say, detached homes within a larger area). The wholesale charges are assumed to be identical, due to geographic averaging by the incumbent water company.

Table 1 illustrates that, even if a NAV was efficient in terms of its site-specific relevant costs, a cost-plus approach may lead to the NAV making an excessive margin for Development 1 and an insufficient margin for Development 2. Hence, while the NAV could compete to provide services to both developments, it would have a disincentive to compete for services to Development 2 (and an advantage in competing for Development 1 which does not reflect higher efficiency). This concern would not arise under a wholesale-minus approach.

Table 1: Illustrative examples of cost-plus and wholesale-minus pricing

		DEVELOPMENT 1 (LOW COST)	DEVELOPMENT 2 (HIGH COST)
Wholesale charges (A)		100	100
Site specific relevant costs (B)		5	15
Cost-plus	Bulk charges (C)	90	90
	Gross Margin (D) (A – C)	10	10
	NAV's economic profit (D – B)	5	-5
	Would a NAV compete?	Yes	No
Wholesale-minus	Bulk charges (C) (A – B)	95	85
	Gross Margin (D) (A – C)	5	15
	NAV's economic profit (D – B)	0	0
	Would a NAV compete?	Yes	Yes

Productive efficiency is about providing services at the lowest possible cost. A wholesale-minus approach allows NAVs to compete for the on-site services. Competition from NAVs provides incentives for incumbent water companies to be efficient in the provision of on-site services. A cost-plus approach could achieve a similar outcome. In addition, it would also ensure that incumbent water companies are efficient in the provision of bulk services – i.e. the provision of bulk water to the boundary of a new development. In the water sector, our approach to cost

assessment as part of our price review process largely performs this role, although there may be scope for a cost-plus approach to go further.

We consider that the regulatory burden on NAVs and incumbent water companies could potentially be larger under a cost-plus than a wholesale-minus approach. To decide on a determination under a cost-plus approach, we would need to estimate the cost of supply for services that represent a large proportion of total costs. Under a wholesale-minus approach this assessment would instead be limited to a much smaller set of costs. A wholesale-minus approach could limit the **risk of incurring errors**.

On the basis of this high-level assessment we have reached a preliminary conclusion that a wholesale-minus approach, such as the one described in detail in Section 4, would be preferable. We are particularly concerned that a cost-plus approach may fail to achieve a level playing field between incumbent water companies, SLOs and NAVs. In particular, because of the geographic averaging of retail charges, a cost-plus approach may prevent NAVs from competing for developers' services, even when they are efficient.

Implementing the wholesale-minus approach

We have provisionally concluded that a wholesale-minus approach would be preferable. There are two broad approaches to implement it: either we deduct (i) the incumbent water companies' costs from the relevant wholesale tariff(s); or (ii) the costs of a reasonably efficient benchmark.

If we deducted the incumbent's costs, we would ensure that only operators as efficient as the incumbent could enter the market and make a sufficient margin. Under some circumstances, this approach may not lead to optimal outcomes. For instance, there may be instances where end-customers and developers may benefit in the long run from the entry of NAVs in a particular area that may appear relatively inefficient in the short run, but that have the potential to become more efficient in the long run. This could be the case when NAVs either grow in scale and scope over time or when competition can spur incumbent providers to experiment with more innovative solutions.

Questions

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

Q3 Do you agree with our assessment of the options and our provisional conclusion in favour of 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.

4. Our proposed guidance

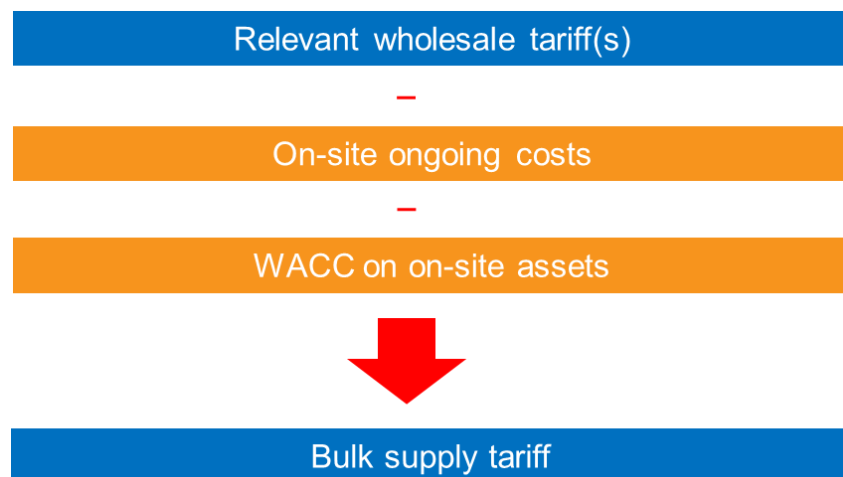
In this section, we discuss our proposed guidance under a wholesale-minus approach. We also cover the following:

- how our proposed approach is able to adapt;
- standardisation of charges;
- information provision; and
- treatment of the income offset.

Our proposed wholesale-minus approach

Figure 1 provides an overview of how we propose to implement our wholesale-minus approach. The rest of this section details the three key elements in our proposed wholesale-minus approach.

Figure 1 – Relevant starting point for wholesale-minus approach and costs to be deducted



The proposed relevant starting point

Our current guidance suggests that the LUT should be used as the basis for negotiations, as long as the forecast demand by the NAV qualifies. We understand that before the retail business market opened in England, incumbent water companies often used their retail LUT as the starting point or as the actual bulk supply charge they offered NAVs. We do not consider that setting bulk charges at the retail LUT level would be appropriate. Instead we believe that if the LUT was used as the starting point, this should be net of the gross retail margin – i.e. the relevant wholesale LUT. This is because NAVs also provide retail services to their end-customers. Prior to the opening of the business retail market to competition it may have been appropriate to start from the retail LUT and deduct the retail costs, however, the availability of the wholesale LUT now makes this step redundant. We understand that some incumbent water companies have already moved to a wholesale LUT as the relevant starting point.

In Section 3 we expressed a provisional preference for a wholesale-minus approach. This was largely driven by the fact that because of the geographic averaging of retail charges, a cost-plus approach may prevent NAVs from competing for developers' services, even when they are efficient. Therefore, we consider that the wholesale LUT is also no longer an appropriate starting point. This is because the LUT was considered a good proxy for the incumbent water company's costs to supply up to the boundary of the site. Therefore, using a wholesale LUT as the relevant starting point would be akin to adopting a cost-plus approach. Instead, under a wholesale-minus approach we consider that bulk charges should closely relate to the services a NAV provides to its end-customers. As a general principle, the relevant starting point should be the set of incumbent water company's wholesale tariffs that reflects the NAV's potential end-customer base. This requires creating an "overall weighted average" tariff that would reflect the combined wholesale charges of all the NAV's customers. Some sites may just have residential end-customers, while others may focus on businesses or have a mix of end-customers (see Box 1 for an illustrative example).

An advantage of a starting point based on the incumbent water companies' wholesale tariffs is that the bulk charges can change over time to reflect changes in incumbent water companies' tariffs. This ensures that an appropriate margin to provide the on-site services is retained over time. For example, wholesale charges will change depending on the level of the revenue caps we periodically set or because of the effects of the introduction of competition. This flexibility is required also to take into account any changes that take place in the composition of the

NAV's end-customers – e.g. in case some residential are substituted by business end-customers.

Box 1: An illustrative example on how to derive the starting point

This example illustrates how to obtain an "overall weighted average" tariff when a NAV supplies a mix of end-customers. In this illustrative example, we consider a set of residential and business end-customers. However, there could be further variations within each type of end-customers, e.g. large or small businesses, but also residential, end-customers.

Suppose the new developments included:

- *10 residential end-customers, each on the following wholesale residential tariff:*

$$P_{(R)} = 10 + 1*q, \text{ where } q = \text{the volume of water consumed}$$

- *5 business end-customers, each on the following wholesale tariff:*

$$P_{(B)} = 8 + 0.5*q, \text{ where } q = \text{the volume of water consumed}$$

The starting point overall weighted average tariff ($P_{(Bulk)}$) could be set up as follows:

$$\begin{aligned} P_{(Bulk)} &= (10*10 + 8*5) + [1*(10/15) + 0.5*(5/15)]*q \\ &= 140 + 0.83*q \end{aligned}$$

Relevant costs

We consider that there are two sets of relevant costs that should be deducted from the relevant starting point (Figure 1). The discussion in this section reflects the categories of costs that are most likely to arise. However, in some circumstances either not all costs mentioned may be relevant or it may be necessary to deduct the costs of other services to the relevant starting point – e.g. if the NAV self-supplied water treatment, water resources, waste water treatment, etc.

On-site ongoing costs

The first set of costs to deduct relates to the ongoing costs of operating and maintaining the on-site assets. These should reflect the activities that the NAV is expected to perform on the site. For example, whether these include any costs for emergency responses, will depend on whether the NAV or the local incumbent water company has this responsibility.

We could use the cost of the incumbent water company. While new assets are, initially, less likely to require the same level of maintenance as older assets, what matters is the average maintenance costs that incumbent water companies can be expected to incur over the entire life of the assets. This must also include the expected costs in later periods when repairs and maintenance costs would be higher. Therefore, it would be inappropriate to assume that the new assets, such as the on-site infrastructure for a new development, will have very low maintenance costs simply because they would be newer than the assets currently in the ground. On the other hand, we would be prepared to accept substantiated evidence that demonstrates new assets may have lower maintenance costs over their entire life cycle relative to the existing assets.

If, instead, we used the costs of a reasonably efficient benchmark, we would have to define how such a benchmark may look like – e.g. it may be smaller in scale and scope of activities than the relevant incumbent water company. Under this approach we would need to provide sufficient information to ensure that incumbent water companies could set their bulk supply charges in accordance to our guidance.

The WACC for on-site assets

We also need to deduct from the relevant starting point the reasonable return or the Weighted Average Cost of Capital (WACC) on the on-site assets.

Regardless of whose costs are used, there are arguments that the relevant WACC should be estimated by:

- removing the effect of regulatory protection that incumbent water companies enjoy. This could be seen as an advantage enjoyed by incumbent water companies that, under the current regulatory regime, a NAV would be unable to replicate irrespectively of its efficiency relative to the incumbent water company. There is therefore a case for adjusting the WACC to level the playing field; and

- taking into account the fact that the relevant risk relates to the investment in the site and not to the incumbent water company's entire regulated (and often unregulated) business. Either incumbent water companies or NAVs would be able to raise finance for a new development on the basis of the risk of their overall business portfolio. The risk related to the new development will also affect the WACC, though this would be most likely a small component. While a NAV would not be able to replicate the exact scope of the business of the incumbent water company, its overall WACC may or may not differ from that of the incumbent water company.

These considerations and, in particular, that discussed under the first bullet above would imply that the appropriate WACC could be higher than the unadjusted incumbent water company's WACC.

If it was appropriate to adjust the incumbent water company's WACC, this would raise practical considerations. We are aware that considerable time and work was necessary to estimate the appropriate WACC in the [Priors Hall](#) determination.¹⁵ Given this, we consider that there would be practical advantages in agreeing a simple methodology to establish the appropriate WACC to deduct from the relevant starting point. This could take the form of an agreed mark-up on top of the incumbent water company's WACC, but are keen to explore further with industry how to set up a simple practical methodology.

Costs not to be reflected in bulk charges

We do not intend to describe all the costs that should not be included in bulk agreements. However, for clarity, we consider it is helpful to specify two types of costs that we consider should not be factored into bulk charges. These are:

- **Costs recovered from developers:** The type of costs that need to be deducted from the relevant starting point are those that incumbent water companies would have recovered from their end-customers. This is an important consideration as in any new development upfront costs are recovered from developers. For example, developers pay for the costs of rolling-out the on-site network, connecting the latter to the local incumbent

¹⁵ This was our determination of bulk charges charged by Anglian Water to Independent Water Networks Limited for the supply of potable water and the discharge of waste water to the Priors Hall site, in Corby Northamptonshire, under sections 40, 40A and 110A of the Water Industry Act 1991.

water company's nearby network and for any network reinforcement the latter needs to undertake. The upfront costs of these services are already recovered from developers and, therefore, should not be recovered from end-customers. They should therefore not be considered for the purpose of setting bulk charges.

- **Offsite costs:** Incumbent water companies might incur incremental, on-going costs that are driven solely by the new development. For example, suppose the site of the new development requires the installation of additional pumps to maintain water pressure for the site's end-customers - e.g. on the top of a hill. While, in this example, the upfront costs for the pumps should be recovered from developers via the infrastructure charge, any ongoing running costs, such as the energy used to operate these pumps, are recovered from end-customers. However, the geographically averaged nature of retail charges means that these costs are recovered from all existing customers of the incumbent water company, both on and off the new development site. Therefore, we see no case for these costs to be added to the relevant starting point.

Standardisation of charges

The type and scope of bulk services a NAV needs to purchase from the incumbent water company may vary depending on the approach the NAV adopts on the site and the local circumstances. Therefore, potentially each site could have its own bespoke bulk charges. The latter have the potential to cater for the needs of each site. However, we consider that setting tariffs on a site-by-site basis would be complex, time consuming and provide no or limited information to NAVs. We are also aware that some incumbent water companies are currently in discussion with some NAVs to set NAV-specific, but standardised, bulk supply tariffs. Therefore, we consider that it is possible and appropriate to set bulk charges that cater separately for a standardised set of bulk services. For example, these could distinguish between water and waste water and/or vary depending on the type and number of premises involved and the type of on-site infrastructure.

As a result, we consider that there would be considerable benefits if incumbent water companies made an effort to standardise their bulk charges. We also understand that, for a, potentially limited, number of sites with specific and non-standardisable requirements, the incumbent water companies' bulk charges may need to reflect the specific features of the site and the needs of the NAV. Therefore, some bulk charges may be bespoke. We would expect these to be exceptions and incumbent water

companies to make efforts to provide as much upfront standardised information on bulk charges as possible.

Adaptability

We consider that our proposed approach is sufficiently flexible to be adapted to changes to the existing circumstances. A possible example of a future change is the new water resource and network plus price controls for wholesale water and waste water in PR19. Some NAVs already self-supply water resources or other elements of wholesale services and more may take advantage of market reforms in England in the future. The new wholesale controls will provide greater transparency of incumbent water companies' costs and so will allow bulk charges to better reflect the avoided costs.

This guidance should not be seen as exhaustive in terms of possible current or future scenarios. Future reforms may impact the types of services that NAVs could source and from which provider. If this is the case, the proposed wholesale-minus scenario could and should be adapted to reflect the new circumstances.

The provision of tariff information

We consider that there are benefits from incumbent water companies publishing relevant charging information. This principle and the reasons behind this are explained and set out in our charging rules for [new connections](#), [retail](#) and [wholesale](#) charges.

Publication of bulk charges or the method for setting them are key for NAVs, as they need to secure a bulk agreement, at least in the form of a quote, before bidding for developers' jobs. Therefore, NAVs ought to have access to clear information on bulk charges ahead of bidding for developers' work in order to ensure a level playing field.

We understand that incumbent water companies may only be subject to obligations to publish their bulk charges if, and when, we publish charging rules on bulk supply. However, we want incumbent water companies to adopt best practice and consider publishing standardised (as far as possible as discussed above) bulk charges for the most common situations that an incumbent water company may face in its own area.

In some (rare) cases, charges in relation to a particular site may need to reflect unforeseen circumstances and may therefore need to be customised or bespoke. Even in these circumstances, NAVs would benefit from knowing in advance the methodology for setting bulk charges applied by the incumbent water companies. This would allow them to estimate what the bulk charges may be when considering bidding for developers' services.

Bulk charges may also need to reflect changes in the incumbent water company's wholesale charges and in the composition of the NAV's end-customer base over time. We consider that it would be good practice for incumbent water companies to take the initiative and update their bulk charges to reflect such changes, but in any case they should do so promptly when a NAV requests the bulk charges to be updated. Failing to do so would open up the risk of a NAV requesting a determination.

The treatment of the income offset

An 'income offset' is a discount on an incumbent water company's charge for providing a sewer or water main. It reflects the income the incumbent water company will receive from a new development. It can therefore reduce the cost of connecting new housing developments to the water network.

In our October 2017 Decision "[New connection charges for the future – England](#)", we concluded that the current treatment of the 'income offset' was an impediment to a level playing field for NAVs, as currently they rarely benefit from it. To address this concern, we decided to net-off the 'income offset' from the infrastructure charge, rather than against the requisition charge as is currently the case. In future bulk agreements, NAVs would only be required to pass back the 'net infrastructure charge' to the incumbent water company, thus ensuring they are not disadvantaged. This change will come into effect from 1 April 2020.

To get the benefits from a more even playing field as soon as possible, as a temporary measure, we have decided that incumbent water companies should include the payment of the 'income offset' in their new bulk agreements from 1 April 2018 to 31 March 2020. Hence, for this period bulk supply charges may also reflect this change.

Questions

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

Q6 Do you agree with our proposed relevant starting point?

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

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?

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

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

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

5. Next Steps

We welcome your views on our proposals and in particular feedback on the specific questions set out in the chapters by **08 January 2018**.

We intend to issue our finalised guidance after we have considered responses to this consultation. This guidance would then take immediate effect and it would not have retrospective effect – i.e. it will only apply to agreements that are referred to us for a determination after the date when this guidance is finalised.

We also intend to issue charging rules about bulk services when the relevant changes made by Water Act 2014 are brought into force. We will consult on draft charging rules before we issue them, but anticipate incorporating relevant elements of our guidance on bulk charges into future rules. We will have regard to the relevant charging guidance from Defra and the Welsh Government, as required by legislation. Our preliminary view is that the content of our guidance is consistent with existing draft UK and Welsh charging guidance.

Appendix – Glossary

Incumbent water company	A water company for whom we set individual price controls. Although sizes vary, an incumbent water company will normally be significantly larger than a NAV. All incumbent water companies have their own water resources and treatment facilities.
Water company	A company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991. It includes incumbent water companies and NAVs.
NAVs	A water company that has replaced, or will replace, one or more incumbent water companies in relation to specific sites and for whom we do not currently set individual price controls. Although a NAV can operate its own treatment facilities, a NAV normally obtains a bulk supply of water from, and/or agrees a bulk discharge of waste water to, an incumbent water company.
NAV site	A site for which a NAV is the water company.
End-customers	Household retail customers and business retail customers.
Bulk supply	Supply of water from one water company to another.
Bulk discharge	Supply of waste water from one sewerage company to another.
Bulk services	Bulk supplies and bulk discharges.

Bulk supply agreement	A contract setting out the terms and conditions for bulk supply.
Bulk discharge agreement	A contract setting out the terms and conditions for bulk discharges.
Bulk agreements	Bulk supply agreements and bulk supply discharge agreements.
Bulk charges	The charges for bulk services, i.e. bulk supplies and bulk discharges.