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8th January 2018

Dear sir

Response to the Ofwat consultation on bulk charges for NAVs

Operating as a NAV, IWNL has been concerned that the competitive market for new connections has been foreclosed for many developments. We recognise that Ofwat has taken significant steps to address market failings and to create a framework to better facilitate a competitive market; this includes:

- The development of New Connection Charging Rules to be implemented from 1st April 2018; and
- The Decision Document on Income Offset issued on 2nd November 2017.

Ofwat's consultation, "*Bulk charges for NAVs: a consultation*", setting out proposed guidance on how Ofwat will determine disputes on bulk supply charges, is another important part of the jigsaw. We believe such guidance is essential in creating a more level playing field for NAVs.

Our responses to the consultation questions are provided in Appendix 1 to this letter. In summary, we believe new guidance to supplement that published in 2011 is essential.

Ofwat states¹:

"...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 negotiations where the NAV's forecast demand qualifies. Any costs that

¹ Page 13, under the heading "Online guidance relate to NAVs"

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”.

An important key difference between a NAV and other large users is that the capacity required for NAV connections will be largely diversified for domestic use. NAVs are not able to respond to price signals in large user tariffs around seasonality, time of use or peak loads in the same way that a single large commercial or industrial user could. Therefore, consideration needs to be given to the structure of the tariffs to NAVs to ensure they are more reflective of the customer profile. To do this, incumbent water companies need to consider how they notionally charge their own notional downstream business where they operate networks that are equivalent to those operated by NAVs.

If there are any aspects of our response you would like to discuss further please contact me.

Yours faithfully

Michael Harding
Regulation Director

Appendix 1

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

Yes. The Frontier Economics report following the investigation into the NAV market confirmed that competition does not work well at present. It also identified the two main barriers as the treatment of income offset and the boundary charges to NAVs.

We recognise that Ofwat has made a lot of progress in addressing the market failings and creating a framework for a competitive market. This has three bedrocks:

- New Connection Charging Rules to be implemented 1st April 2018.
- The Decision Document on Income Offset issued on 2nd November 2017.
- Bulk Charges for NAVs, which is the subject of this consultation.

The first two matters have been effectively addressed. The market will still not function properly, though, without resolution of the issues around bulk charges for NAVs. Consequently, we see the need for supplementary guidance as critical. Without this, the New Connection Charging Rules and Income Offset will have limited impact.

The supplementary guidance will ensure incumbents apply a consistent and proper approach in developing bulk supply tariffs to NAVs. The approach proposed by Ofwat, or something very similar, is already needed to comply with the provisions of competition law but it is an obligation that has been largely honoured in the breach. To date a collective failure across the industry has perhaps provided false comfort for water companies in not addressing their responsibility to offer cost reflective charges to all customers, including NAVs.

We believe that the current approach that many incumbents use to determine the bulk supply tariffs results in margin squeeze for many prospective NAV sites and, therefore, distorts competition. Progress by incumbent water companies to address competition concerns has been very slow. We see the development of clear guidance as essential to give incumbent water companies the impetus to progress the development of tariffs to NAVs without delay. This is needed by 1st April 2018 if the full benefit of the other reforms is to be realised.

We recognise that Ofwat has reminded incumbents on several occasions of the need to comply with the requirements of competition law. The publication of effective supplementary guidance setting out clear principles and approaches does not substitute competition law, nor does it resolve competition issues in itself; however, we think it will provide a clear message to incumbents on the approach they need to take to resolve issues that NAVs face.

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

We agree with the purpose, scope and objectives. We agree that NAVs must be free to choose which services they require from the local incumbent water company (both water and waste water). We agree that bulk charges should be flexible and relate solely to the services a NAV requests.

The current treatment of bulk supply agreements by incumbent water companies is one of the main barriers to market entry for NAVs. We agree that the aim for the guidance should be to promote a level playing field between incumbent water companies, SLPs, developers and NAVs.

We therefore agree with the purpose, and objectives of the proposed guidance though believe there are some areas either missing or that require further clarification. We further discuss these in our response to question 5 below.

We believe there should be an additional objective to create the level playing field specifically by 1st April 2018. As water companies have existing duties under competition law and licence obligations, they should already be offering cost-reflective NAV charges. Hence a workable solution by 1st April 2018 should be achievable and required. This also ties in with the date for the New Connection Charging rules and also the change to Income Offset stated in the Decision Document (2nd November 2018). As mentioned in our response to Q1, those developments will have limited impact on competition if this bulk charge issue is not addressed at the same time. As water companies have recently analysed distribution and retail costs for the introduction of competition to the NHH Retail sector, relatively little work should be needed to create a NAV bulk charge. Moreover, we note that we have been pushing water companies to create such tariffs for a very long time and have consistently said that they should do so by the time the new connection charging rules come into force. The better, more forward-thinking water companies have accepted that challenge and the rest should be made to catch up.

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

We agree that the use of a wholesale-minus approach is strongly preferable.

As Ofwat has noted (at page 26), the existing approach of starting with a large user tariff (LUT) can be seen as akin to adopting a cost-plus approach because (theoretically at least) the LUT is supposed to reflect costs incurred on average by the incumbent in providing the bulk supply. Using the LUT as a starting point has, however, ruled-out competition for the vast majority of sites because (amongst other things) it fails to recognise that the end-customer residential charges have little or no connection to the costs incurred in serving the particular demand.

We would go further than saying that this is just a matter of “low cost” or “high cost” sites, as suggested in the consultation. Although on-site costs certainly can vary, and this could give rise to the inefficient entry issues mentioned in the consultation (pages 21-22), our experience is that on-site costs do not typically vary a lot for similar looking developments.

The arguably bigger issue is one that arises from the required uniformity of end-customer charges. Being required to charge the same end-customer charges to existing and new customers, and regardless of geographic location, results in a situation where some customers may well subsidise others. Revenues will not necessarily cover costs at any particular site. More broadly, existing customers may well subsidise new customers such that new customer revenues will not cover costs (except, perhaps, at the very lowest cost sites).

The consequence of this is that a NAV will not necessarily earn enough revenue to cover its costs even if it is more efficient in providing the on-site network and only faces cost-reflective charges for the up-stream network. As such, we question Ofwat’s suggestion (page 22) that a cost-plus approach could achieve a similar outcome on productive efficiency. All customers will benefit if NAVs compete down on-site costs for new developments, but this will not happen unless the focus of competition is, indeed, on the on-site costs – and we believe that can only happen with wholesale-minus charges.

We also do not agree that cost-plus pricing has any particular advantage in ensuring that incumbent water companies are efficient in the provision of bulk services. Although that view might be correct in theory, the reality is that bulk services for NAVs will only be a small factor for incumbents over the foreseeable future. Regulatory price controls in relation to end-customer charges are likely to have a much larger impact in driving efficiency for the various cost elements involved in supplying bulk services.

We agree that using a cost-plus approach would make it a much more complex and resource intensive exercise for both the incumbent and, where required, Ofwat to assess what the charges ought fairly to be. As Ofwat suggests (page 23), the extra complexity would increase the risk of error. It would also increase the risk of delay in finalising appropriate charges and make it harder to police incumbent's compliance with their obligations.

In summary, we agree that the use of a wholesale-minus approach is more likely to achieve a level playing field. However, this will only be the case if an appropriate cost standard is used for the costs to be deducted from the wholesale price. We are concerned that unless clear guidance is given, incumbent water companies may default to only deducting a subset of the costs in their methodologies for calculating bulk supply tariffs, probably only short-term avoided costs. We discuss this further below.

We would also note that one of the (few) virtues of starting with the LUT is that it is, at least presumptively, cost-reflective on average and the numbers will have been established largely without concerns about losing business to competitors. The risk with creating wholesale-minus NAV-specific tariffs from scratch is that they may not be as robustly cost-reflective and there may be a temptation to err on the side of charging NAVs too much given the competitive context.

As far as we are concerned, the introduction of wholesale-minus pricing should lead to better NAV prices in the vast majority of situations. This is for a number of reasons:

- First, there are the retail pricing "subsidy" issues noted above that suggest that prices to new residential end-customers may be less cost-reflective than LUTs.
- Second, LUTs ought to include a premium for the increased risk of bad debt and stranding of assets that exists with industrial and commercial customers relative to NAVs or residential customers.
- Third, we would expect large users to require more upstream capacity than typical residential developments for the same total water usage because there is not the same diversification of demand.

In the circumstances, we would be concerned if the introduction of wholesale-minus prices resulted in prices *rising* above existing LUT-based tariffs for the sites that are most open to competition. We have seen some suggestions that might happen. We will be monitoring the situation closely but would welcome a reminder from Ofwat about the importance of allocating costs properly and of the point that action is being taken, at least partly, because existing LUT-based charges to NAVs have been too high to allow any significant level of competition.

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.

We agree with the broad approach identified. In a normal 'mature' market we acknowledge that the benchmark should be the costs of an equally efficient operator; i.e. incumbent water company's costs. However, as Ofwat recognises, the market for NAVs is immature and yet to develop and using incumbent water companies' costs as the benchmark may therefore inhibit the development of a market which would lead to long term efficiencies for consumers. Therefore, we think there are potential long-term benefits to the overall market in using costs of a reasonably efficient benchmark in determining the NAV tariffs – at least for an initial period.

In particular, we note that it is not possible for NAVs instantly to replicate the scale economies available to larger incumbents simply as a result of their historic monopoly position. The fact that these scale economies arose out of historic advantages rather than as a result of success in a competitive market may be considered a relevant factor since it shows that current performance may not be a good indication of how the incumbent would perform relative to newcomers when those undertakings achieve a comparable scale. In short, the incumbent may well be less efficient once the advantages of size are stripped away and both incumbent and newcomer are compared on the same basis. As such, dynamic considerations may favour the use of a reasonable efficiency benchmark even if not considered optimal in a static analysis.

We would favour an approach of using costs initially benchmarked in some way on those of smaller incumbents, who lack the economies of the scale of the largest undertakings, but perhaps with a glidepath towards achieving parity with the costs of incumbents over a period of years.

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

We agree with the proposed overall approach. However, as indicated in our response to earlier questions, such approach should fully recognise that in providing the network:

- the NAV is substituting the network and services associated with operating and maintaining the network that the incumbent water company would otherwise provide;
- that the majority of substituted networks will be on new residential developments, which have large on-site networks with main and service pipes plus multiple retail customers. Hence the incumbent cannot consider the NAV site as similar to a large single user, which is a large part of the current issue; and that,
- it is the total costs avoided by the incumbent water company that should be used in determining the NAV tariff; i.e. overheads, customer facing costs and costs of operating the network.

We believe that the total avoided costs should be determined by reference to long-run average incremental costs. This is consistent with the conclusions in Frontier Economics' report and with the benchmark used in competition law cases for margin squeeze.

In setting the tariffs, the relevant test for water companies to apply should be whether margins made available to NAVs are at least consistent with the margins that the incumbent water company's own notionally equivalent arms-length business would require to operate an equivalent network and make a reasonable profit.

We also note Ofwat's objectives for this consultation include providing 'NAV's with the confidence that they have sufficient and timely information on which to bid for developers' work.' It is essential NAVs have clarity and visibility of bulk charges to enable us to present

competitive bids to developers, without the need to interface with the incumbent water company. With the delayed introduction of the New Connection Charging rules in April 2018, developers are expecting competition to start then. An essential part of Ofwat's approach must be to address the bulk charge issue with effect from 1st April 2018.

Q6 Do you agree with our proposed relevant starting point?

The relevant starting point should be "*...the set of incumbent's tariffs that reflects the NAV potential end-customer base*". This would be consistent with the way the incumbent water company would levy charges if it owned and operated the network. However, the Ofwat guidance actually states; '*the relevant starting point should be the set of incumbent water company's wholesale tariffs that reflects the NAV's potential end-customer base.*'

The reference to 'wholesale tariffs' is a concern as all water company wholesale charges are used for NHH customers. They are not used for residential developments, which form the majority of the NAV market. The inclusion of the word 'wholesale' could encourage water companies to use their NHH wholesale charge that reflects the total load for the site, requested by the NAV. A NHH wholesale tariff could then be used as the 'starting point for negotiation' and we will be back to the same issue as we face today.

We take some comfort in the associated guidance that '*this requires creating an "overall weighted average" tariff that would reflect the combined wholesale charges of all the NAV's customers.*' But again, the use of 'wholesale' could be misleading as wholesale charges do not apply in the residential market.

We believe Ofwat's intent is correct but urge for further clarity in this area. It may be just removing 'wholesale' helps to achieve this.

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

We agree that ongoing costs of operating and maintaining the on-site assets should be deducted. We think, that as a minimum, it is the costs of the incumbent water company that should be used.

We believe there is merit in considering using the costs of a reasonably efficient benchmark; we have suggested above one way in which this might

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?

We do agree with Ofwat's discussion about the WACC and, in particular, we do think that the incumbent water company's WACC should be adjusted along the lines of the Prior's Hall determination.

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

In order to make the adjustment to WACC practical to implement, we would suggest simply increasing the WACC by 2% in each case on a pre-tax basis.

This would be broadly in the middle of the range of uplift proposed by Ofwat's consultants for Anglian Water in the Prior's Hall determination; the consultants proposed a pre-tax WACC of 6.6% to 7.8% compared to a PR09 pre-tax WACC of 5.1%. Given that even a full assessment in the case of Prior's Hall resulted in a range of 1.2% between the highest and lowest appropriate WACC values, we would suggest that there is little value in attempting a more precise estimate in any given case. As an alternative, Ofwat could establish a strong presumption as to the uplift to be applied but leave it as a possibility that incumbents (or new entrants) might be able to overcome the presumption in specific cases – albeit only by showing good reason for departure from the reasoning of the consultants in the Prior's Hall case.

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.

One specific area that water companies need to consider is the industry requirement to flush water pipes on new developments to achieve mandatory hygiene standards. We estimate that this requires a volume of water of 3 x the capacity of the entire site networks. This is a significant volume and required no matter who installs the network, the incumbent, an SLP or a NAV. However, only the NAV is charged for this water, as the incumbent insists on a site boundary meter/s. As there is no resident or developer bill to offset the cost, the NAV has to bear the charge. The incumbent must allow for the same requirement when it, or an SLP, installs the site network. The bulk charge to the NAV must pass on the same value to a NAV. This does have a significant impact on the NAV, as it is an early cost when the NAV has very few end customers so limited revenue. The NAV is already funding initial capital works, so the additional bulk charge for flushing adds another layer of cost. The structure of the bulk charge to NAVs needs to consider this profile for inclusion of the cost against NAV income.

We appreciate that the New Connection Charging rules are outside of the scope of this consultation. However, the consultation by the water companies has, on the whole, been very poor. In most cases they make no reference to the connection charges a NAV will incur relating to the connection of its assets to the incumbent water / wastewater company network. There is no detail on the type or level of charges. This is a significant issue. Currently water companies apply a range of connection related charges to NAVs that they do not apply to their own connections business or to SLPs. Whilst we expect all water companies to provide this transparency, the poor standard of consultation suggests they have failed to do so. Our preference is for this to be addressed in the New Connection Charging rules. However, there may be a requirement for the water companies to address this in their bulk charges to NAVs to create the level playing field if they choose not to.

The connection charges imposed on NAVs include the following:

- a. Network analysis / modelling / feasibility studies.
- b. Network design for actual point of connection / discharge to the incumbent's network.

- c. Admin fees when a NAV applies for a point of connection / discharge to incumbent network.
- d. Boundary metering charges. The same charge is not applied to other parties including incumbent's direct offer to developers and to SLPs. Please note that we see no need for a boundary meter. All homes on our sites are metered and a settlement system can be used to drive billing information, like the wholesale model used in the non-household market. The settlements solution is also used in electricity and gas markets. In electricity, the regulator advised that the party who wanted the boundary meter pays. We support the same approach in water.

There are also customer facing costs that should also be deducted. Whilst some of these costs fall to be recovered under the retail element of charges, there are some costs that do not. Such costs should also be deducted from the incumbent's tariff.

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

We believe such an approach should be sufficiently flexible to cover current circumstances. However, we think there should be sufficient flexibility to review and update the guidance in the light of experience and as the market develops.

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?

We believe it should be possible for the majority of sites to covered by standardised charges. However, the structure of such standardised charges need to recognise the number of properties on a NAV site so that the fixed customer facing charges avoided by the incumbent water company are identified. Such costs could be incorporated into the volumetric component of the charge (as a reduction), or as separate negative charge per property to be deducted from the total charge.

As stated in Ofwat's objectives, water company charging schemes should provide '*NAVs with the confidence that they have sufficient and timely information on which to bid for developers' work.*' Standardised charges remove the need for discussions between the NAV and incumbent for bulk charges for each site. IWNL requested generic NAV bulk charges from Yorkshire Water, who offered site-specific charges. The two sites were relatively small standard residential developments. Negotiations are on-going after 18 months. This provides a clear example of the problems of NAV reliance on the incumbent before it can make a competing offer to a developer. It is important that NAVs have confidence and timely information and standardised charges remove this barrier to competition.

By exception there may be a few very large sites with circumstances where it is appropriate to develop site specific charges. This is where the network is complex; and where it may also provide support services to the incumbent water company. Based on experience in the electricity sector, in the early stages of competition, incumbents claimed lots of sites were non-standard and hence outside of the standard charging rules with the new entrant reliant on the incumbent. This has been addressed over a number of years, so non-standard sites are by exception and for defined criteria.

Q13 Do you agree with our proposal for the provision of tariff information?

We agree that charges to the fullest extent possible should be published in a transparent manner. Additionally, we believe that incumbent water companies should be required to publish the methodologies they employ to determine their charges. Such transparency would assist NAVs in determining likely charges for future developments and determine whether they believe the charges are consistent with Ofwat's guidance and with competition law.