

## **Northumbrian Water Response to Bulk charges for NAVs: a consultation**

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

The proposed guidance is useful and we welcome the opportunity to comment on it. As the consultation closes on 8<sup>th</sup> January, we presume the final guidance will be issued in late January / early February. This is very late for companies to include in the 2018/19 charging scheme.

We strongly agree with the preference for a wholesale minus approach. This leaves the incumbent regionally averaged wholesale charges scheme intact and allows NAVs to quickly assess the viability of their schemes.

It also avoids the complexities of any cost plus approach. Such an approach would require a great deal of cost modelling and each supply price would have to be bespoke. As a result, NAV charges could not be published in advance and NAVs would face not knowing their charges until after a lengthy cost calculation, most likely after the NAV has made commitments to the housing developer. We also agree it could discourage efficient entry or even result in NAVs being delivered that are less efficient than the incumbent could supply.

**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.**

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

**Q6 Do you agree with our proposed relevant starting point?**

In our view, the level playing field test should be that a NAV that is equally efficient to the incumbent should be able to effectively supply the site. To make that assessment, the comparison must be made on an avoided costs basis – so the NAV receives a discount equal to the costs the incumbent would have incurred if it delivered the site.

This is a well established economic principle and should ensure efficient entry without cross subsidy by the incumbent customer base.

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

### **On site ongoing costs**

We agree that these should reflect the activities the NAV is expected to perform (and hence the incumbent has avoided). Whilst it is true that the costs of new infrastructure are lower in the short term, we suggest that a more practical calculation of the avoided costs would be to average the whole life avoided costs over time rather than to try to constantly change margins over time depending upon the life of the assets. This is the way incumbent charges are set and we feel the NAV approach should mirror this to avoid excess complexity and contradictions.

**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?**

### **The WACC for on-site assets**

We do not agree that the incumbent water companies enjoy greater regulatory protection than the NAVs. Through the protection of this charging guidance, NAVs have a great deal of regulatory protection to ensure they earn a return on their investment.

The Priors Hall case makes reference to the protection from volume risk an incumbent has. It is not clear to us that the volume risk that this addressed is different between NAVs and incumbents. As NAVs typically receive a bulk supply on a volumetric tariff, it is arguable that the revenue volume risk from customers is transferred from NAVs to incumbents via this volumetric tariff. The fact that NAVs typically replicate the incumbent end tariffs suggests to us that, de facto, they are regulated in the same way as incumbents.

Also, since then, there have been competitive markets created for water resources and bioresources, neither of which will apply for a typical NAV. As such, the assumptions in the Prior Hall case need revisiting by Ofwat before it can be assumed to be continuing. As Ofwat say, a considerable amount of work would be required to recalculate this before it could be relied upon.

We are also concerned that Ofwat seem to be suggesting that a NAV could have a higher WACC due to its relative size. We would challenge that assumption, as this would suggest that an allowance should be made for a NAVs lower financing efficiency than the incumbent. Ofwat's recent comments on not allowing a higher WACC for smaller water only companies in PR19 is instructive in this area.

Finally, customers of the incumbent should not be required to subsidise the customers of a NAV, on the grounds that a NAV has higher financing costs. It is up to NAVs to finance themselves in a competitively efficient manner. Many NAVs are part of much larger organisations, some of which are larger than many incumbents (e.g. SSE).

**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?**

### **Costs not to be reflected in bulk charges**

In general, we agree that upfront development costs should be recovered from developers (or the NAV if they are acting on behalf of the developer) as an upfront charge rather than as part of ongoing bulk charges.

**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?**

### **Standardisation**

We agree that standardisation of NAV charges would be very helpful for all parties. For this reason, wholesale minus charging is the only appropriate way to allow for this.

Ofwat should acknowledge that standardisation (and publication) of tariffs will require a degree of regional averaging. Thus, it would help if Ofwat could confirm that they do not intend to 'unpick' this averaging by looking at site specific costs in determinations.

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

### **The treatment of the income offset**

The offsetting of the income offset against infrastructure charges from 2020 onwards should ensure that the level playing field for NAVs and incumbents is transparent. We agree there is a case for removing the income offset altogether from 2020 onwards, as it is a subsidy from existing to new customers that is not rational in economic terms.

We do have concerns over the temporary (2018-2020) proposal that income offsets should be applied to bulk supply charges. As income offsets are typically multiple years of revenue, this would effectively make the charges negative.

For this reason, we suggest that the income offset should be treated as a capital contribution in the regulatory accounts, to avoid any interactions with the revenue cap and general wholesale charging.

### **Further discussions on the treatment of the income offset 2018-20**

We note that, for 2018-20, the NAV will receive a large income offset that it can use to finance its investment in the site mains laid.

It does not seem right to us that this part of the costs should also be treated as avoided by the incumbent in the NAV tariff calculations, as this will result in incumbent customers paying twice for the NAV assets – once in the income offset and again in the NAV tariff discount. We would welcome further discussions with Ofwat on this, as we are not sure this is what was intended in the guidance.

**Northumbrian Water  
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