Ofwat
Bulk Charges for NAVs

Severn Trent Water response

8 January 2018

Summary of our response

The charges set by water companies play a critical role in promoting efficiency and delivering the right outcomes for customers, society and the environment. In relation to new connections, the charging structure plays an important role in (i) promoting competition; and (ii) incentivising behavioural change.

We therefore agree with the need to ensure a level playing field between incumbents, NAVs and self-lay organisations. This is why we created a separate charge for NAVs, based on the wholesale-minus approach which is now Ofwat's preferred option.

While we disagreed with Ofwat's approach to new connection charging - providing an "income offset" to NAVs - we accept that this is now Ofwat policy. In line with the consultation, we will be continuing with our existing approach until the end of AMP6 – however, we would highlight that there are some transitional issues.

Our existing NAV tariff accounts for the cost of new on-site infrastructure (the "income offset") within the NAV discount. Under Ofwat's future approach, incumbents should provide the income offset to all parties making a connection (including NAVs) and the developer should pay for that infrastructure. The consultation is clear that such costs should not be reflected in the wholesale-minus discount going forward

This presents some issues for NAV sites that are already operating – their business cases will have been based on the presumption that they will receive a given level of discount for the duration of their appointment, and will have paid for all of their own infrastructure. Any reconciliation to the new approach would be complex and – more importantly – it will not be possible for a NAV to go back to a developer for the portion of the infrastructure cost that the developer should have paid years after construction.

Our solution – which we have discussed with the NAVs that operate in our area – would be for all NAVs that have started operating before the end of AMP6 to continue on the legacy tariff. We would apply a new (lower) discount to any new NAVs, reflecting the fact that they would not have to fund the cost of on-site infrastructure. We believe that this is a pragmatic solution which provides the certainty which the NAVs require to continue operating.

We have some specific points in response to the questions included in the section below. If you have any questions regarding this response, please feel free to contact me.

Regards,

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Response to consultation questions

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

We agree with the need for this guidance and are supportive of the overall approach. In 2016, we recognised that there were issues with our existing approach to NAV bulk supplies because – amongst other things – our charges did not allow sufficient margin for sites that were too small to qualify for our Intermediate User Tariff. This is why we introduced a bespoke NAV tariff in 2017-18.

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

We understand the need to create a level playing field in new connections and support this objective. Our aim in creating the NAV tariff was to ensure that NAVs were able to compete for the provision of local infrastructure.

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

A wholesale-minus approach is simple and proportionate. We think the availability of a published NAV discount gives NAVs the certainty they require in order to put together a business case for an unserved site. We accept that there will be sites which are difficult or costly to serve and will be making changes to our NAV tariff for 2018-19 that take these into account – for example, we will take into account sites where there are large commercial customers and sites where additional pumping may be required.

A cost-plus approach would be extremely complex, involving site-by-site estimations. Given that many sites are developments of less than 100 homes – making them too small to qualify for an Intermediate User Tariff before we introduced our NAV charge – such an assessment and any subsequent challenge to it would be disproportionate to the level of revenue that the site would generate. In addition, we agree that this type of approach would be in tension with geographical averaging applied to incumbent charges.

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.

An incumbent has little choice but to apply an Equally Efficient Operator approach, using its own costs. It does not have access to the information that would be required to create a hypothetical efficient operator – this type of entity would need to be constructed by Ofwat. That would be complex and time-consuming given that the nature of each site will vary. As we discuss in response to the questions below, Ofwat would need to make assumptions about (amongst other things) the mix of properties on site, the length of connecting mains, materials, the profile of maintenance and how to take account of higher cost sites where pumping, treatment or storage is required.

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

We agree with the overall approach, which is broadly in line with the NAV charge we have already developed (except for the exclusion of new on-site infrastructure costs which are provided for separately under Ofwat's new approach to connections).

Q6 Do you agree with our proposed relevant starting point?

The wholesale charges paid by customers on site is the right starting point. The simple example may need to be expanded to take account of all different types of charges paid. For example, there is an element of margin already available to the NAV by virtue of the fact that it collects multiple standing charges, but only pays a single charge to the incumbent. Similarly, for bulk discharges in the Severn Trent area a NAV will collect property-based surface water charges from its customers but pay a single site-area charge to Severn Trent if it connects.

For a standard charge, an assumption that all properties are domestic is reasonable. Our charge takes account of the typical mix of properties (for example, detached, semi-detached and other), their consumption and the on-site costs that would be involved in connecting them. Where large commercial customers are connected, a specific charge would need to be calculated and we intend to make allowance for that in our 2018-19 Scheme of Charges.

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

Ofwat is seeking to create a level playing field for the connections in new developments. The costs in such sites will not be the same as the average costs for the remainder of an incumbent's network, which is comprised of legacy assets that are - in many cases - over a hundred years old. The incumbent network has been inherited from multiple authorities which previously supplied water and not planned by a single entity. In our view, the right approach is to look at the profile and timing of costs over the lifetime of the assets on site.

New developments are supplied with modern materials where the initial costs of maintenance will be very low and leakage – aside from defects on installation – should be very low. Before creating our NAV tariff we examined our own data on the relationship between asset lives and maintenance costs, demonstrating a rising trend over time.

Our approach looked at the present value of the revenue that would be collected on site and the present value of the costs – including the higher maintenance costs that would be expected towards the end of the accounting life for the new assets. The discount smooths those costs (because it is a single rate) – it therefore takes account of both the costs and their timing.

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?

A NAV operator is a competing wholesaler – it is competing to design, build and finance local infrastructure. When establishing a NAV tariff the incumbent will use its own WACC because it is applying an Equally Efficient Operator test. While the scope of the NAV's business differs from the incumbent it enjoys many of the same protections – its end-user prices are the same as the incumbent's and are therefore index-linked, guaranteed for five years at a time. In addition there are a number of risks and costs that it does not bear – for example, it faces a significantly lower regulatory burden. Generally speaking NAVs do not treat their own water or waste water and therefore their interaction with the quality regulators is limited.

From a practical perspective, in a present-value based approach which looks at the costs of the assets over their lifetime, increasing the WACC will reduce the significance of future costs and revenues. This will impact the level of discount if costs are expected to be higher in the future.

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

We think that assessing the effect of the specific factors which increase or reduce a NAV's risk profile relative to an incumbent will be extremely subjective and contentious. In looking at the position of the upstream Resources control, and the downstream Bioresources control, Ofwat has taken the position that these should have the same WACC as the overall company. We think it would be consistent to start from the same position with regard to the downstream market in new connections.

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.

When constructing a standard charge, our approach has been to assume a standard length of mains and sewers per plot, which drives the level of maintenance required. Each customer on site will also have a meter which needs to be maintained or replaced at the end of its useful life.

Most sites will be gravity fed, with long mains connections (from the trunk main to the site) and will not include on-site pumping or storage. On site treatment is also rare. Given how variable these factors can be, we don't think it is reasonable to include them within a standard charge; these should be taken into account in bespoke discounts for the sites that require them.

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

The general principle of a wholesale minus is the right approach. Provided NAV discounts that are published can take account of differences in bespoke costs, we think this method is workable.

As noted in the introduction, changes in Ofwat's approach – which costs should or should not be included – can have an impact on NAVs that are already in operation. We think that Ofwat needs to give some consideration to this if future changes should have an impact on bulk supply agreements that are already in operation. Our preferred approach for NAV bulk supplies that start before the change of new connection rules would be to "grandfather" the existing discount – upon which the NAV will have planned its business - and start any new NAV on a revised tariff.

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?

As we discuss in response to Q10, most NAV sites are domestic developments with a gravity feed and a relatively short mains connection. A standard charge can work for these circumstances. Where sites do not fit this mould, the discount would need to be adjusted to take account of those specific factors. But this should not diminish the case for standard charges where they are possible, as they provide greater certainty for planning purposes to both NAVs and developers.

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

We support the publication of standard NAV bulk supply terms, which we included within our Scheme of Charges starting in 2017-18. Having consulted with NAVs operating in our area, we will be including further information about the nature of the sites that are reflected in the discount and the circumstances where a bespoke rate would need to apply from next year.