



Charging
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Strategy & Regulation

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Dear Sir

BULK CHARGES FOR NAVS: A CONSULTATION

We welcome the opportunity to respond to Ofwat's consultation on bulk charges for NAVs. In our area we have the largest concentration of NAVs of all the water companies, and the growth of new developments in and around London means this is likely to continue. NAVs play an important role and we have been working closely with NAVs and others to support them. For example, we ran a NAV study group in 2017 focussed on their needs and on delivering a better service to meet these.

We agree that bulk charges are an important part of an agreement between incumbent and NAV, and we welcome the further clarity that guidance on the setting of these charges can provide. Our detailed responses to the consultation questions can be found in the appendix to this letter, and for ease we highlight some specific points below.

Level playing field

We support competition on its merits and agree that increased choice for developers can facilitate the entry of efficient competitors, and ultimately benefit end-customers. We note, however, that to ensure that there is efficient competition, it will be important that any proposals do not give NAVs an unfair advantage over other delivery options, for example, private supply networks (with whom NAVs are in direct competition). It would be helpful if the guidance were clearer in this respect.

We also note that a level playing field does not require all competitors to be competitive in all circumstances. It would not, for example, be expected to allow market entry of competitors who were of an inefficient scale, or who were unable to raise capital efficiently.

On-site ongoing costs

Ofwat identifies two possible reference points for on-site costs. We believe that using the incumbent's costs, for networks with equivalent technology (a majority of an incumbent's existing costs relate to technology which is no longer used for extending the network) to determine on-

site ongoing costs would support efficient entry and protect existing and new customers from paying bills that were higher than they otherwise would need to be (in other words, it avoids entry that is inefficient, at least in the short run).

If Ofwat was to set on-site ongoing costs based upon a “reasonably efficient benchmark” test, it would need to be clear how to set the benchmark, how to adjust the benchmark over time and how customers are protected while the NAV is less efficient than the incumbent.

Whichever reference point Ofwat adopts, we consider that on-site costs need to reflect the likelihood that maintenance costs increase over the lifetime of assets. An ‘average cost’ approach is one option, although a judgment would need to be made about the period over which the average is taken and the likely rate of increase in cost over time. An alternative option is to set costs to reflect the ‘contemporary’ costs of maintaining on-site assets. Such costs would be low initially then increase over time when the need for maintenance increases.

Standardisation of charges

As long as its place within the process of bilateral contract negotiation is recognised, we support the idea of standardisation of charges. As the water company with the largest concentration of NAVs within its area we are keen to engage with Ofwat and the industry on the provision of tariff information that would be of most value to NAVs.

We look forward to working closely with Ofwat on the area of bulk pricing for NAVs. If you would like to discuss any of these points in more detail, please contact Paul Steffens in the first instance (paul.steffens@thameswater.co.uk).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Colm Gibson', is written over a light blue rectangular background.

Colm Gibson
Head of Economic Regulation

Appendix – Detailed responses

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

Bulk charges are an important part of an agreement between an incumbent and a NAV. We welcome the further clarity provided by the consultation on how charges could be set, and feel that practical and proportionate guidance can support appropriate investment decisions and can reduce scope for conflicts between NAVs and incumbents. Also, given the ability for new developments to be supplied via a number of delivery options, it will be important for Ofwat to be clear that its guidance does not give undue advantage to NAVs over alternatives.

As an aside, we feel that the actions already proposed by Ofwat to address issues within the NAV market and the (pending) change in the treatment of income offset, will support effective competition 'for' the market.^{1,2} The supplementary guidance should be considered in the context of the actions already proposed, and the improvements they are likely to result.

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

We broadly agree with the purpose, scope and objectives of Ofwat's proposed guidance. We support any move to facilitate competition between NAVs and incumbents in the provision of developer services and services to end-customers, as such competition can improve outcomes for both developers and end-customers. We consider that guidance should apply to disputes between an incumbent and a NAV concerning the charges of the bulk services the NAV requires to serve its end-customers. Bulk charges should be set flexibly relating to the services that a NAV requests. It would be helpful if Ofwat set out in its guidance how it will ensure the benefits of competition are passed to end-customers and what the scale of such benefits would likely be.

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

We agree with Ofwat's assessment that a cost-plus approach could incentivise NAVs to enter low-cost areas even when it was inefficient to do so, and deter NAVs from entering high-cost areas even if it was efficient to do so. Ofwat's assessment highlights the cross-subsidy inherent in setting average retail charges on a geographic basis and the tensions created when some companies are free to choose where they can compete in a regulated market.

We agree that a wholesale-minus approach has a number of advantages relative to the cost-plus approach: it restricts the risk of supporting inefficient entry and deterring efficient entry, it imposes a lower regulatory burden, and it limits the risk of errors.

¹ See Ofwat, "Study of the market for new appointments and variations – summary of findings and next steps", published on 10 October 2017.

² See Ofwat, "New connections charges rules from April 2020 – England: Decision Document", published on 2 November 2017. In particular, we expect that paying an income offset to a NAV which is the same value as if a developer were engaging a self-lay provider or an incumbent to carry out the works to provide new infrastructure will help NAVs to compete for developers' services.

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 believe using the incumbent's costs in a wholesale-minus approach would support efficient entry and protect existing and new customers from paying bills that were higher than they otherwise would need to be. In our view, such scope for entry is consistent with Ofwat's objective to create a level playing field.

Using the incumbent's cost has two further advantages. First, incumbents know (and can be expected to know) their own costs (which is practical), and secondly, it avoids the burden and uncertainty of Ofwat having to define a "reasonably efficient benchmark" and to determine the costs of such a benchmark.

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

Subject to the three key elements being appropriately determined (see our responses to Q6-Q8), we broadly agree with Ofwat's proposed approach. However, we would be concerned if competition for the provision of services to developers and end-customers was promoted based on potential benefits that may not be delivered and without sufficient regard to the inefficiencies it can give rise to. For instance, we note that the consultation does not distinguish between the impacts on static and dynamic efficiency in considering efficient on-site entry even though there will be trade-offs between these types of efficiency.

Q6 Do you agree with our proposed relevant starting point?

We agree in principle with the proposed starting point as the end-customer base is clearly relevant to the retail revenues that can be generated.

In practice, we foresee a number of issues with an approach that depends on customer information that incumbents may not have access to.

- It gives rise to administration and data collection costs, and it increases scope for misunderstanding and conflicts.
- Incumbents have no automatic right to this type of information. They would likely have to reserve the right to require data assurance on information provided to them, and/or ask for it to be written into the contract they agree with a NAV.
- The weighted average needs to be regularly updated to reflect changes in customer mix and usage patterns.

Close interaction between Ofwat and the industry should be able to address these issues. If Ofwat opts for this starting point, we would welcome further clarity on how NAVs and incumbents should collect, provide, and use the customer information needed to determine relevant wholesale tariffs (including relevant consideration of data protection regulations).

As NAVs predominantly supply household end-customers, Ofwat could consider setting relevant wholesale tariffs based on household tariffs (as default) then allow for corrections to be made where (and to the extent that) NAVs supply non-households as well. This would appear to be less onerous than calculating a weighted average tariff.

Ofwat's consultation does not specify the volumes to which the weighted average tariff should be applied. We propose applying this tariff to volumes of water supplied by the incumbent (as opposed to volumes of water consumed). Practically, volumes supplied to residential and business end-customers could be determined by applying the split between water consumed by both types of end-customers to the volumes of water supplied as measured at the boundary of the NAV's inset.

This would provide NAVs with appropriate incentives to limit leakage and to bill its end-customers for water consumed. Also, it would be practical as the incumbent is able to measure volumes of water supplied at the boundary of the NAV's inset. We encourage Ofwat to clarify its proposals on this matter, and would happily contribute to any discussion on how to determine relevant water volumes in practice.

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

We appreciate that deciding on the approach to estimating ongoing on-site costs is challenging. It appears to us that there are two options. The first option involves taking average maintenance costs over the lifetime of on-site assets; the second option setting costs to reflect the 'contemporary' costs of maintaining such assets.

Over the lifetime of the NAV, both options would likely lead to similar outcomes, but we believe the second option provides more certainty during the life of the NAV and avoids the potential for short-term inefficient entry to occur, with its costs being passed on to end-customers. The first option would require regular review and adjustment to ensure deducted costs are correctly averaged, as well as decisions on the lifetime over which costs should be averaged and the discounting of future costs. The second option would involve setting costs to reflect the 'contemporary' costs of maintaining on-site assets. Such costs would be low initially then increase over time as maintenance costs increase.

If average maintenance costs over the lifetime of assets were to be used, it will be important to have regard to costs over the lifetime of new assets. These costs could be significantly lower relative to older assets as technological progress has increased resilience of networks over time, which will reduce maintenance costs. The industry (both incumbents and NAVs) can inform Ofwat on the technology and materials they would use to build infrastructure for new developments, and on the maintenance costs associated with newly built infrastructure over time.

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?

It is not clear to us that making any deduction in respect of the WACC in the period 2018-2020 is appropriate in the light of Ofwat's temporary arrangements requiring incumbents to offer an income offset to NAVs. If the incumbent pays for the NAV's on-site assets, NAVs should not be allowed returns on assets they have not paid for as that would offer NAVs an unfair advantage. We ask Ofwat to consider whether a WACC deduction on on-site assets should only be allowed once temporary arrangements have been phased out and only on the amount invested by NAVs on the relevant infrastructure.

Furthermore, we consider that allowing NAVs a mark-up on incumbents' WACC should not go beyond compensating for any additional undiversifiable risks that NAVs cannot mitigate themselves (if any) and should be substantiated by robust evidence. While we accept that a higher WACC could be justified where NAVs experience greater undiversifiable risks, more work is needed to assess their relevance and materiality. Caution is warranted as allowing NAVs a higher WACC in the absence of an objective difference in undiversifiable risk, could support the entry of capital inefficient NAVs.

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

As noted in our response to Q8, applying a higher WACC requires Ofwat to show that disadvantages experienced by NAVs justify a higher return on the on-site assets held by NAVs. An increase in WACC should adjust for any greater (undiversifiable) risk that NAVs face and that they cannot mitigate for themselves. It should not go beyond this, as allowing NAVs disproportionately greater returns on their on-site assets could provide them with an unfair competitive advantage against other delivery options.

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.

While we are currently not aware of any other costs that should be deducted from (or added to) relevant wholesale tariffs, we recommend that the guidance does not restrict the scope of costs that can reasonably 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?

If the concerns we have raised above are addressed, we are confident that Ofwat's approach can be sufficiently flexible to cover current circumstances and to 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?

Yes. It should be possible to develop a methodology that can be used to set bulk charges in most circumstances. Ofwat and the industry should be able to overcome practical challenges and to progress standardisation of charges over time, covering more circumstances and benefitting from improved understanding of the information that is most relevant to NAVs. We recommend that incumbents retain some discretion in applying the published methodology so that they can account for bespoke aspects relevant to a case.

Circumstances requiring bespoke charges could be where the characteristics of demand in a NAV site are non-standard, e.g. businesses requiring high demand for short periods or households' requirements varying over time reflecting variation in their self-supply via black/grey water recycling.

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

We agree there are benefits from incumbents publishing relevant charging information, including bulk charges and the methodology they use to set bulk charges. Access to clear information on bulk charges will help in the development of a more competitive market for network extensions for new developments.

Incumbents should play their part in improving access to new markets, most practically by publishing standardised bulk charges for the most common situations that they face in their own supply areas. As the incumbent with the largest concentration of NAVs within its area, we are keen to engage with Ofwat and the industry on the provision of tariff information that would be of most value to NAVs. Such provision should reflect the place of published tariffs and tariff methodologies within the continued process of bilateral contract negotiation.