United Utilities response to the Ofwat consultation on bulk charges for NAVs

8 January 2018

Introduction

United Utilities welcomes the opportunity to comment on Ofwat's consultation on bulk charges for NAVs.

We are supportive of Ofwat's proposed wholesale-minus approach to setting bulk charges for NAVs. The approach should ensure that efficient entrants have an incentive to compete for developer services and facilitate the development of the NAV market.

The three key elements of the proposed approach (the relevant starting point, on-site ongoing costs and the WACC on on-site assets) are considered in detail in the responses below. In summary:

- We agree that the starting point should reflect the NAV's end user customer base to ensure that bulk charges provide appropriate margins for efficient NAVs.
- We recognise Ofwat's considerations in terms of whose costs should be used to determine on-site ongoing costs. We consider the right approach is to use the costs of the incumbent water company as this should provide an appropriate level of margin for NAVs in the context of avoiding inefficient entry.
- As per the reasoning set out in the Priors Hall determination, the appropriate WACC should be project specific rather than benchmarked against any company's portfolio of risks. Ofwat should be cognisant that setting a WACC which is too high could be distortionary to the market (including the market for self lay providers) and could lead to inefficient entry and non-entry decisions.

We recognise the benefits to a NAV of standardising and publishing the bulk charges, ensuring that NAVs have access to transparent charging information ahead of bidding for new developments. However in some instances this may tend to lead to inefficient decisions by NAVs either to compete or not to compete. There are many different types of sites and types of services required by NAVs and therefore there will be occasions where the site specific costs do not fall within the predetermined set of standard bulk charges, potentially resulting in insufficient or excessive margins. The balance between transparency and facilitating efficient on-site entry needs to be carefully managed in order to ensure that pricing for NAVs is fair overall, with scope to manage instances where a NAV margin would be either insufficient or excessive. We note that NAVs will only be incentivised to highlight circumstances where they consider the margin insufficient – they are less likely to highlight circumstances where a margin would be excessive.

As noted in the consultation, the guidance will not have a retrospective effect. We strongly agree that it would not be appropriate to apply any changes retrospectively, as existing NAVs entered into bulk supply agreements in good faith based on the prices offered, which the NAVs deemed acceptable at the time. In addition, existing NAVs will need to recognise and accept that forward looking charges will be recalculated in accordance with the new guidance, regardless of whether this results in a lower or higher charge. Otherwise this would incentivise multiple appeals by NAVs where they observe a charge increase (whereas charge decreases would be unlikely to be appealed.)

Consultation questions

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

We support the proposal for additional guidance to supplement the bulk supply pricing principles.

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

We support the overall purpose, scope and objectives for the proposed guidance.

We note that the scope only applies to bulk services from an incumbent water company to a NAV, and not for bulk services between incumbent water companies (often known as 'water trades'). We consider it appropriate that the pricing approach differs for the two different types of bulk services. Incumbents have a duty to supply new developments served by a NAV, whereas water trades are non-obligatory and are subject to negotiation between the incumbent water companies. For a water trade, the exporting incumbent should set the bulk charge so that at a minimum all incremental costs incurred are recovered. This is to ensure that the exporting incumbent can meet its existing obligations and customer bills are not adversely impacted.

Ideally there would be one guidance document which covers all types of bulk services. If this is not considered possible, the guidance should clarify that an alternative approach applies to water trades and provide reference to the relevant guidance document.

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

We are supportive of the proposed wholesale-minus approach to setting bulk charges for NAVs, based on the assessment of the two options outlined in the consultation. We agree that the cost plus approach could lead to inefficient entry and non-entry incentives for NAVs due to geographically averaged charges, whereas the wholesale minus approach will recognise the differing costs a NAV would be incurring on different developments.

A wholesale minus approach also aligns more closely to the current methodology used when pricing a bulk supply to a NAV than a cost plus approach. In addition, applying a wholesale minus approach is similar to the approach that Ofwat has adopted for access pricing since the proposed equalisation payment for access prices is effectively a wholesale minus approach. The objectives are the same for the two markets, i.e. to encourage efficient entry, so the approach should be the same.

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 that deducting the incumbent water company's costs would ensure that only NAVs as efficient as the incumbent could enter the market.

As noted in the consultation document, there may be instances where a NAV is relatively inefficient in the short run but has the potential to be equally efficient to the incumbent in the long run. Therefore, if it could be estimated, a 'reasonably efficient benchmark' may be considered appropriate to facilitate the development of the NAV market.

However such a benchmark is usually defined by the market itself and as the NAV market is not widely developed, it is unclear where Ofwat could obtain the information necessary to make a robust and accurate estimate of a reasonably efficient benchmark. As a result, it seems entirely plausible that misestimating the reasonably efficient benchmark could lead to inefficient decisions on entry and non-entry. If Ofwat were to determine that it wishes to make such an estimate and that incumbents should apply it then we consider that this approach could only be justified if applied for a time limited period, recognising that in the long term the NAV market should be mature and equally efficient. This will avoid inefficient entry in the long term and therefore protect customers interests.

The standard wholesale tariff of the incumbent that is used as the starting point is based upon the incumbent water company's costs, not an externally estimated benchmark. Therefore we consider use of the incumbent company's costs to be the most appropriate basis for making deductions to the wholesale charge. In addition, incumbent average costs should provide reasonable headroom for NAVs, as the incumbent average costs will be calculated based on a range of developments (including both efficient and inefficient developments), resulting in an appropriate deduction which is not unreasonably low.

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

We agree with the high level proposed approach for setting bulk charges for NAVs.

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

We agree that using wholesale tariffs that reflect the NAV's end user customer base is an appropriate starting point.

In UUW's case the large user tariff (LUT) already includes a discount for not using all of the local treated water distribution network. Therefore, if the LUT was used as the starting point it would be important to ensure that there is no duplication of costs being deducted in calculating the discount as this would result in too great a discount being applied.

Alternatively, and perhaps more appropriately, using the wholesale non-household standard tariff could be used as the starting point with explicit deductions made from that level.

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

We are supportive of deducting the on-site ongoing costs, and agree that costs should reflect the average operational and maintenance costs over the entire life of the assets.

Estimating whole life costs will require a definition of the standard life of infrastructure assets. Each incumbent can make their own assumptions based on their own company specific information. However if the aim is to apply discounts that are consistent across the industry, data would need to be collated from incumbents to determine a suitable industry average. In this case, these should be centrally collated and independently issued so as to maximise the consistency of approach and minimise the regulatory burden on incumbent water companies. We do not consider that it would be appropriate for companies themselves to collate and calculate such information for the purposes of price setting.

The typical activities that a NAV is expected to perform on site will vary for each site and a NAV will design and build its own on-site network. The way in which it chooses to do this will drive the level and types of operational and maintenance activities performed. Therefore we anticipate that defining a set of typical activities that a NAV will perform at a site will be somewhat subjective and may lead to disputes where the NAV disagrees with the deduction for on-site ongoing costs. This will particularly be the case where NAVs make design decisions which lead to less efficient delivery of operational and maintenance activities.

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 consider that the starting point for Ofwat's analysis of an appropriate WACC should be in line with the reasoning set out in the Priors Hall determination –that is, that as a general principle all project appraisals should be conducted using a project-specific cost of capital which captures the systematic risk of the project.

On this basis, neither the WACC estimated by Ofwat for the incumbent water company nor a NAV's overall portfolio WACC should affect the cost of capital assessment and therefore it would not be appropriate to "adjust" the incumbent water company's WACC – instead, the WACC should be based on a project specific basis. As noted in the consultation, considerable time and work was necessary to estimate the appropriate WACC in the Priors Hall determination.

If Ofwat instead considers that the WACC should be benchmarked against its estimate of an incumbent's WACC then it is important to recognise that given a NAV's limited exposure to risk compared to the overall market (beta will be significantly less than 1), the cost of capital should certainly be less than the average market cost of capital. In its consultation Ofwat itself notes that a NAV's own overall WACC "may or may not" differ from that of the incumbent water company.

The WACC should not be set so high as to encourage inefficient entry. In UUW's area, NAVs are primarily in competition with Self Lay Providers (SLPs) for initial provision of on-site assets. Allowing inefficient entry could distort this market. Therefore we consider that it is particularly important to establish that in setting the level of the WACC NAVs are not given undue advantage in comparison to SLPs.

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

As explained in the response to question 8, we consider it to be complex to estimate an alternative to using the WACC of the incumbent water company. If Ofwat considers that it is appropriate to apply a mark-up on top of its estimate of an incumbent water company's WACC, the mark-up will need to be provided explicitly in guidance. We consider that by its very nature the level of mark-up is likely to be highly subjective as it cannot be directly observed by incumbent water companies.

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.

Wholesale costs associated with the non-household ('NHH') retail market - such as market operator charges - should be deducted from the wholesale non-household standard tariff starting point. This will ensure that NAVs do not contribute towards costs which are not relevant to them (being the incumbent's non-household retail market charges.)

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

We consider that the proposed wholesale-minus approach is sufficiently flexible to cover most current circumstances and known future changes. As noted in the consultation, it is not possible to predict all future scenarios, and therefore the approach may need to be amended at some point to reflect future reforms.

As explained in the response to Question 2, the relevance or otherwise of the pricing approach for water trades should be included (or referred to) in the guidance for completeness.

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 consider it possible to produce standard bulk charges for NAVs but consideration must be given to the balance between transparency and facilitating efficient entry and non-entry decisions.

Standardisation of charges provides transparent charging information for NAVs. However as there are many different types of sites and types of services required by NAVs. Highly standardised charges will result in 'winners' and 'losers' which may lead to inefficient entry and non-entry decisions. For example, standard bulk charges may provide insufficient margins for efficient NAVs where a development has very high site-specific relevant costs. Conversely, the margins may be too high for developments with very low site specific relevant costs, e.g. due to different geographical conditions. Bespoke bulk charges better facilitate efficient entry decisions, albeit at a cost of a more limited level of transparency and would take longer to calculate.

Setting a set of standardised charges would require a number of charges to be determined in order to provide appropriate prices, for example, considering the relationship between the number of premises and the costs of the development, alongside the property type. It is likely to result in different standard prices for developments largely consisting of high rise towers, developments of large detached houses, developments of industrial warehouses/manufacturing plants, and scenarios in between.

Specific circumstances where the standard bulk charges would not be appropriate include:

- Where a NAV is not required to invest in their own on-site network - for example, a NAV appointed under the 'large user' criteria. In this case, the applicable large user wholesale tariff would be most appropriate, in order to maintain a level playing field between NAVs (and their customers) and large non-household customers. This is in line with the proposal set out in the Frontier Economics report commissioned by Ofwat.
- A development with significant non-infrastructure requirements – for example a site including pumping stations due to the geography of the land and storage assets to manage end-user peak demand, resulting in site-specific costs that are much higher than the average.

There will be instances where standardising bulk charges will result in a NAV considering the margin to be insufficient. This has the potential to result in disputes and therefore an appropriate and proportionate appeals process needs to be in place. As determining bespoke bulk charges is complex and time-consuming, we consider it appropriate that a mechanism is implemented so that a NAV reimburses the incumbent water company for the costs and time spent calculating a bespoke charge, where it is found that the bespoke charge is not materially different to the relevant standard NAV charge. This should drive the correct behaviour by incentivising NAVs to only appeal where they are confident the standard charge is not appropriate for a particular site.

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

We recognise the benefit to NAVs of published bulk charging information. The form this takes will depend on whether bulk charges are to be standardised or bespoke. Standardisation of charges will enable publication of charges, whereas for bespoke prices the methodology could be published. Both approaches provide a level of transparency to NAVs.

As noted in the consultation, it would be good practice for incumbent water companies to take the initiative and update their bulk charges to reflect changes in the incumbent's wholesale charges and in the composition of the NAV's end-customer base over time, and that failing to do so would open up the risk of a NAV requesting a determination. However, it also needs to be considered how disputes can be avoided in the instance of changes resulting in adverse impacts to bulk charges. This might occur, for example, as a result of the lowering of Ofwat's estimate of the cost of capital due to the periodic resetting of the incumbent's WACC and the consequent reduction in the deduction from standard wholesale charges.

Due to the considerable significance of the questions being raised around how the price for a NAV should be set and the scope for prices to be materially impacted by these issues, at this time we do not consider it appropriate to publish a NAV tariff. However, we do support publication of this information once the approach to these issues is clarified and/or updated guidance is in place and we will move swiftly to implement such an approach in order to drive best practice.

End of questions (13 questions)