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Dear David

Wessex Water's response to Bulk charges for NAVs: a consultation

Thank you for the opportunity to respond to this consultation. We support the broad thrust of your proposals.

Greater competition in the delivery of services to developers is an opportunity for real value to be created for customers, and our aim should be that the market is set-up in a way that promotes innovation.

We should also consider the potential for greater use of markets , and should explore the potential for further market reform, perhaps ultimately to include allowing incumbents to exit the market above a certain size.

Promoting innovative solutions

There are clear opportunities from a thriving NAV market: better outcomes can be achieved that deliver services in different ways and benefit customers. To ensure these potential new approaches are encouraged, where a NAV is proposing an innovative solution that results in long-term upstream or downstream benefits for the incumbent, the avoided costs should be allowed to be deducted from the calculated bulk supply price.

The balance between timeliness and bespoke pricing

The tension between providing bespoke, cost reflective prices that are relevant to a specific site and the need to provide timely, transparent information remains problematic.

Charging for developer services has recently gone through a process where market participants have worked together to develop common structures and approaches for charges. NAV charging would significantly benefit from the same approach, and this could increase confidence in the charging regime and improve the functioning of the NAV market.

Providing information

Our preference would be that the requirements to publish additional information should follow more constructive engagement between market participants as detailed above. Without this there is a danger that different approaches taken will act as a barrier to NAV market entry.

We provide answers to your specific questions overleaf, I hope this is helpful.

Yours sincerely

Phil Wickens
Director of Regulation and Reform

Responses to consultation questions

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

We agree with the need for supplementary guidance. We have long been aware of the issues with charging for NAVs and see this work as an opportunity to improve the situation. However in order for the situation to improve, it needs careful consideration, and for the different parties to come together to agree consistent rules to ensure the optimum solution is achieved for incumbents, new entrants and all customers.

We see the potential for greater use of markets in the NAV sector. Looking outside the short term we think there may opportunities to explore the potential for allowing the market to fully decide on the right solution for new developments and allowing incumbents to exit the market above a certain size.

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

We agree. Most importantly your objectives are well thought out and appropriate. We would like to comment specifically in two areas:

1. We agree with the need for a level playing field between incumbent companies and NAVs. We strongly support a NAV market that all participants (both incumbents and new entrants) have confidence in. To do this there will need to be a compromise between the need to provide up-front, timely pricing and detailed, bespoke prices for every request. Ofwat, NAVs and incumbents should work together to ensure this balance is achieved.

2. Your final three objectives are naturally in tension with each other: the need for guidance to be simple to apply is in conflict with the requirement to be flexible to cater to the specifics of individual sites (which will create complexity and take time to produce). This will be the most difficult and complex area to get right, but also critical to ensure prices to NAVs do not:
    - cross-subsidise existing and new customers,
    - delay the development process, and
    - lead to unnecessary disputes that take significant incumbent, NAV and regulator time to resolve.

We are committed to working with you and other market participants to ensure the above issues are addressed.

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

We agree. There are clear opportunities from a thriving NAV market: better outcomes can be achieved that deliver services in different ways and benefit customers. To ensure these potential new approaches are encouraged, where a NAV is proposing an innovative solution that results in upstream or downstream benefits for the incumbent, the avoided costs should be allowed to be deducted from the calculated bulk supply price.

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 cannot identify in the consultation text what your preference is on whose cost should be used. We are not sure how Ofwat would practically determine an efficient benchmark cost to deduct, rather than company-specific costs. A pragmatic solution could be to use company-specific costs in the first instance, but apply tests and comparisons to it to ensure those costs are efficiently incurred.

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

We agree. However the major difficulty, which is not fully addressed in the consultation document, will be finding the right balance between publishing up-front prices that increase transparency and do not result in delays versus bespoke site-based prices that are more cost reflective. We propose working with NAVs and Ofwat to define and agree the best balance.

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

Your proposed starting point of using the forecast mix of domestic and commercial use to set a bespoke end-customer tariff as a starting point is a good proposal where there is a clear mix of domestic and commercial use on a site. This approach however adds complexity. It also requires the NAV to provide accurate forecasts of the mix of domestic and commercial use, which may not accurately be known at the pricing stage. Also in our experience what is planned and what is actually built is often different.

In our experience most new developments are overwhelmingly either domestic or commercial, so a weighted average approach would not be materially different from the standard wholesale domestic or commercial rate. A weighted average approach would therefore be an additional complexity that is not required.

Therefore, in the interests of simplicity we propose that you set definitions where a weighted average approach applies and where a single starting point is more appropriate: we suggest if a new development is over 80% either domestic or commercial, then the relevant single tariff applies.

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

We agree with the high-level principles you discuss regarding estimating the on-site costs. However the difficulty will be applying the approach in a proportionate and reasonable way. As we discuss in our response to Q2, there needs to be a balance between the level of detail and the level of simplicity. NAVs and incumbents should come together to agree the common on-site activities that can be deducted from the end-wholesale charge.

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 recognise the need for the future charging guidance to ensure there is a level playing field for NAVs. The issue of deducting different cost of capital for NAVs throws up interesting questions concerning which customers benefit from competition in the market and which customers pay for it. Ultimately we accept we will need to remain compliant with the Competition Act whatever solution is chosen.

We note there is an expectation that developers will pay in full for on-site works from 2020 and that maintenance of infrastructure has traditionally been funded on a pay as you go basis through customers' bills. This suggests that the total amount of capital on which a return would be substantially lower than the costs of construction.

Where payments are received in advance of construction (as is usually the case) the capital value on which a return should be earned may actually be negative. In this case applying a higher cost of capital would result in a smaller discount from the wholesale charge.

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

Our response to Q8 suggests that the impact of the WACC is not likely to be material. If this proves to be the case then we would suggest an approach that is proportionate to this low level of materiality is appropriate.

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.

We think that your proposed costs to be taken into account are appropriate. We hope that future work in collaboration with NAVs and incumbents will result in a detailed agreed list of the activities that can be deducted from the wholesale charge. This will significantly streamline the process for agreeing a price.

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

There is a clear tension between needing to provide more transparency and simplicity yet ensuring flexibility. We hope that collaborative work between Ofwat, NAVs and incumbents can resolve these difficulties.

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 are in favour of working with you, NAVs and other incumbents to achieve an accepted middle ground between standardised charges specific to an incumbent's area and detailed bespoke charges specific to an individual site.

At one end of the spectrum, incumbents could publish a set of common charges for their region to be applied to a site to result in a charge to a NAV. This would allow perfect transparency in charging, timelier pricing decisions, and possibly fewer disputes (due to a single simple framework that everyone understands). However it may not provide as accurate prices based on the local characteristics of a site.

Conversely an incumbent could be required to calculate bespoke prices based on an individual site's unique characteristics at a very detailed level. This will lead to accurate and cost-reflective prices but generate delays due to the time taken to calculate bespoke prices and potentially a greater number of disputes due to the lack of transparency.

We favour a move to more standardised charges that will streamline the process for calculating charges for NAVs that will increase transparency, trust and confidence. We advocate a similar process to that has been recently carried out for developer charges, bringing NAVs and incumbents together to agree a common set of activities and the level of standardisation that is appropriate.

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

Our license already requires us to calculate and publish access prices each year. We are concerned that any expectation to publish bulk charges without charging rules in place will lead to a variety of different approaches taken, be more confusing for NAVs when requesting bulk supply prices and will make it more difficult to gain consensus in order to meet your objectives.

Our experience thus far is that NAV pricing requests are different each time and that standardised bulk charges for common situations would be misleading without charging guidance in place.

We are strongly in favour of working with NAVs and Ofwat to agree satisfactory guidance in this area before we are expected or required to publish additional information.