Charging
Ofwat
21 Bloomsbury Street
London
WC1B 3HF

Yorkshire Water
Western House
Halifax Road
Bradford
West Yorkshire
BD6 2SZ

T: 01274 804136
M: 07790 616928

By email only

8 January 2018

Dear Sir or Madam,

Bulk charges to NAVs: a consultation

Thank you for the opportunity to respond to the "Bulk charges to NAVs: a consultation".

We have reviewed the consultation and have provided responses to all of the questions that you have included.

If you would like any further clarification please do contact me.

Yours sincerely,

Sarah Shaw

Regulatory Finance Manager

Response to questions within the "Bulk charges to NAVs: a consultation" publication:

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

We agree in principle that there needs to be further guidance to help to facilitate the growth of an efficient market.

Given the pending major changes in new connection charging this supplementary guidance on bulk supply pricing is timely and therefore welcomed.

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

We agree that the purpose of the guidance should be to create a level playing field for all participants.

However, we feel that the guidance should maybe focus more on the provision of services to the end-customers in new developments, and that level playing field in the provision of developer services could be managed through your new connection charging rules.

We also understand that the proposed guidance "is only concerned with disputes under the WIA91" and does not include guidance on competition law.

There is potential that a bulk charges for NAVs methodology may frame future bulk supply price negotiations between water companies and NAVs. It remains for companies to ensure they continue to meet their CA98 obligations.

We agree in principle that the scope should be broad and provide the flexibility required to cover the different services in this market. We also agree that "bulk supply charges should be flexible and relate solely to the services a NAV requests".

We agree with your objectives.

In some ways this consultation on guidance on bulk supply pricing disputes might also be seen as a part pre-consultation on bulk supply pricing rules. We think this is a reasonable approach to these complex pricing matters.

Our response on the guidance detail reflects the quasi-charging rule nature of some of the proposed guidance.

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

We agree in principle to the wholesale-minus approach as this will lead to more reflective incentives for entry into the market.

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 think that costs used should be based on an equally efficient benchmark.

However, we do recognise that this approach (like cost-plus) "*may fail to achieve a level playing field between incumbent water companies, SLOs and NAVs*" – thereby compromising one your objectives.

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

Whilst we agree with the wholesale minus approach we have reservations about providing for a WACC on on-site assets.

In the Yorkshire Water region these on-site assets will have been wholly funded up-front by the developer, so we would welcome more details for why a return differential on these assets should be included as an additional minus in the proposed wholesale-minus equation.

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

Yes we agree with the principle of estimating an overall weighted average tariff as the proposed starting point.

However we do not agree with the illustrative example as this does not take into account the relevant volumes of water/wastewater that is consumed/discharged by the mix of customer types.

This would have to be amended to give an actual 'overall weighted average' tariff.

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

We agree in principle. Ongoing on-site costs are clearly avoided by the water company and need to be deducted from the bulk charge.

We also agree that the costs of capital maintenance and operations should be assessed over the long-term. These infrastructure renewals expenditures may only start to occur many years in the future – possibly even in a subsequent contracting period - but a price allowance should be made from the very start.

In our opinion what really matters is the method selected to determine "*the average maintenance costs that incumbent water companies can be expected to incur over the entire life of the assets*".

The method of averaging could be based on an understanding of future O&M cash flows, the creation of a present value of these expected O&M cash flows and an associated annuity to smooth them back out for bulk supply price setting purposes. Over the long-term whether these expected cash flows are represented as expensed or capitalised (and depreciated) items is not an issue.

There is then a need to establish an appropriate discount rate to construct this annuitized wholesale margin. This may be equivalent to the 'agreed' WACC.

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?

In discussing appropriate returns (or discount rates) it is important to consider the market and the associated risks.

Distinguishing between the "on-site development margin" and the "margin on the service to end-customers" is important in any supplementary guidance. We welcome the explicit recognition of these two distinct market segments – construction and operations - in supplementary guidance. It is important to segment the market in the context of both discussing the cost of capital and determining the nature of the operating costs to be included as avoidable in any future wholesale minus approach.

We believe that the profit embedded in the margin for on-site development should be determined by the emerging market for new connections and would be managed through developer "Site Specific Work" charges and a vibrant contracting market.

In our opinion the margin on the services to end-customers should take "into account the fact that the relevant risk relates to the investment in the site". We would agree that "the risk related to a new development will also affect the WACC". We believe this should be the major consideration.

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

We think the incumbent WACC may be appropriate as a starting point with a small water company adjustment as per Periodic Review determinations.

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 there may be three other cost areas that could be taken into account.

Transaction costs – the NAV is a customer of the incumbent that will need to be managed with associated retailing-like activities such as meter reading, boundary meter management and replacement, billing, payment handling, enquiries, etc. The incumbent water company should be able to recover these legitimate customer management costs. We think there would be no material doubtful debt costs due to the regulatory protections afforded to these smaller water companies.

Overhead Costs – The NAV will also have business costs to recover. Some allowance for running their day-day operations will have been allowed for in the retail margin that will be avoided by the incumbent. The costs of running a notional network operations division (as opposed to the network contracting division that will be funded via charges to developers) will need to be included in any wholesale margin.

Operational Profit - The associated issue of what operational profit margins should be provided to the NAV for efficiently managing the operation of the last few metres of the water/sewerage network. In our view, this would be better addressed via an allowed profit margin on the avoidable operating costs (rather than via a WACC differential). This would be akin to a thick retailing arm of the incumbent with an equivalent profit margin on these low risk operating activities. We think current retailing margins could be used as a starting point.

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

Yes

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 do not think it is appropriate to "*standardise charges under many if not most circumstances*".

As you state "*the type and scope of bulk services a NAV needs to purchase from the incumbent water company may vary depending on the approach the NAV adopts on the site and the local circumstances. Therefore, potentially each site could have its own bespoke charges*". This reflects our current bulk supply charging position.

We understand the regulators desire to improve transparency. And we have considered the suggestions.

Our preferred approach would be publish a limited number of *reference prices* for a set of agreed "*standardised set of bulk services*". These reference prices would be akin to the price benchmarks provided in the oil markets (i.e. Brent blend, West Texas Intermediate and Dubai blend).

As you state such reference prices "*could distinguish between water and wastewater and/or vary depending on the type and number of premises involved and the type of on-site infrastructure*". In our opinion the "standardised set of bulk services" would be very tightly defined and some standard options could even be developed at an industry level.

A reference price could then be published for say i) a new development with houses; and ii) a development with flats – with the above assumptions on property density and ancillary arrangements changing accordingly.

Establishing a limited number of these bulk supply reference prices would be both possible and appropriate.

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

In addition to publishing the above reference prices for "a standardised set of bulk services", alongside, we would agree to publish our bulk supply pricing methodology. NAVs could then understand how their bulk supply price would depart from the aforementioned reference price.

We would then propose to quote an exact bulk supply price – based on the exact site conditions - when we are approached for detailed bulk supply terms. This would be done within the current timeframe of 20 working days, explaining whether and how it departs from the reference price.

This framework of publishing reference bulk supply prices and associated methodologies would then provide the NAV with much greater transparency. But it would not expose incumbents to unnecessary CA98 risks and would minimise the regulatory burden on all participants.