

May 2018

Trust in water

# **Bulk charges for NAVs: final guidance**

## **Appendix 1: Responses to the consultation**

## About this document

In this document we summarise the responses to our ‘Bulk charges for NAVs: a consultation’ which we published on 9 November 2017 (“our consultation document”) and we set out our response to the issues raised. The consultation closed on 8 January 2018. This document should be read in conjunction with our consultation document and our [“Bulk charges for NAVs: final guidance”](#) (“our final guidance”).

In our consultation we invited interested parties to comment on many issues. In particular, we sought views on:

- the need for this supplementary guidance;
- the purpose, scope and objectives for our proposed draft guidance;
- our wholesale-minus approach for setting the bulk charge;
- our overall methodology to calculate the bulk charges;
- our definition and approach to estimate the ongoing on-site costs;
- the flexibility and adaptability of the draft guidance;
- the possibility of standardising charges under many if not most circumstances; and
- the provision of tariff information.

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## 1. Responses to the consultation

Our consultation included the following questions:

### Questions

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

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

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

**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.**

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

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

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

**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?**

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

**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.**

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

**Q12 Do you consider that it would be possible to standardize charges under many if not most circumstances? Can you specify the circumstances where this may not be possible?**

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

We received 23 responses to the consultation: new appointees and variations (7), water and sewerage companies (14), the Welsh Government and the Consumer Council for Water.

Respondents broadly agreed with the purpose, scope, aim and main approach of the guidance. The main issues raised by some respondents and our views on them are discussed in the following section.

We have published [individual responses](#) separately alongside this document except where respondents explicitly stated that their response was confidential.

## 2. Main issues raised in the consultation

This section discusses the main relevant issues raised by the respondents to our consultation, our views and our final decision. For each question we have:

- summarised our position in the consultation;<sup>1</sup>
- summarised the main relevant issues raised by respondents;
- put forward our considerations on the latter; and
- put forward our final decision.

We have published the individual responses separately alongside this document, except in those cases where respondents explicitly stated that their response was confidential.

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

In Section 2 of our consultation document we presented the main reasons for issuing supplementary guidance on bulk supply. First, we referred to the evidence regarding competition in developer services. Second, we mentioned the stakeholders' concerns about current bulk charges. Third, we considered the impact that new markets and forms of control that will be introduced as part of PR19 will have on the information available to set bulk charges.

Almost all of the respondents agreed with our assessment and the need to provide supplementary guidance. They provided several reasons for reforming the current approach, such as the need to foster clarity, remove ambiguities, ensure a level playing field between incumbent water companies and NAVs and improve how this market works. Some respondents highlighted that competition is not working well in the NAV market due to the absence of cost reflective charges for bulk services.

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<sup>1</sup> This is a summary of the position in our consultation to help the reader by providing more context to the question. However, in case of any ambiguity between the two, our position is that expressed in our consultation.

According to these respondents, the bulk supply guidance would contribute to improving the current situation.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
<p>1. One respondent argued that it is unclear how the guidance will contribute to delivering the Welsh Legislative and Welsh Government policy requirements. Moreover, the respondent considered that the guidance partially justifies the need to issue further guidance on factors which are not relevant as regards to Wales<sup>2</sup>.</p> <p>According to the respondent, the Welsh Government has taken a different approach to competition, for instance regarding retail or upstream competition or promoting the NAV market. In fact, the Welsh Government will be considering in 2018 whether the NAV regime should be retained in its present form.</p> <p>The respondent posed no objection to Ofwat proceeding on this guidance as it applies to England. However, it considered that the best way to fulfil the Welsh Legislative and Welsh Government policy requirements was</p>	<p>1. NAVs can at the moment operate in Wales. It is part of our role to ensure a well-functioning NAV market both in England and Wales. Our aim is to create incentives and outcomes that are consistent with the Welsh Government’s aim to create a level playing field, protect competition and allow for efficient entry of NAVs. If the Welsh Government reconsidered and removed the NAV regime in the future, the guidance may perhaps need to be revised for Wales.<sup>3</sup></p>

<sup>2</sup> These include the introduction of retail competition for the non-household customers of English water companies and the policy decisions made in relation to the new connection charges made by English water companies.

<sup>3</sup> The NAV regime may be modified or removed but this guidance may continue to apply to existing NAVs in Wales.

<p>through separate guidance for England and Wales.</p>	
<p>2. One respondent observed that the guidance should not give undue advantages to NAVs over other alternatives.</p>	<p>2. The guidance does not give undue advantages to NAVs over other alternatives. It creates a level playing field to facilitate competition between incumbent companies and NAVs to provide services to developers and end-customers.</p>

## Our decision

We continue to consider and have concluded that there is a need for this supplementary guidance.

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

In Section 3 of our consultation document we discussed the purpose, scope and objective of our proposed guidance. The purpose was to set our approach to future determination requests related to bulk supply charges between an incumbent water company and a NAV. The aim was to create a level playing field in the provision of developer services and the provision of water services to the end-customers in new developments. The guidance would rely on our powers under the WIA91. The scope of disputes which can be referred to us includes charges for any range of bulk services required by NAVs to provide their services to their end-customers. The guidance aimed to help delivering our strategy of ensuring trust and confidence in the sector.

Almost all of the respondents agreed with the purpose, scope and objectives of our proposed guidance. The respondents provided several reasons, such as the need to ensure a level playing field and NAVs' freedom to choose services.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
<p>1. One respondent considered that there should be a guidance covering all bulk services, including incumbent to incumbent water company. If this were not possible, the guidance on bulk charges should (i) clarify that there is an alternative approach that applies to water trades between incumbents and (ii) point them towards the relevant documents.</p>	<p>1. In the consultation, we explicitly stated that the guidance would apply to bulk services between incumbent water companies and NAVs in England and Wales. Currently, we do not consider appropriate to set guidance on bulk agreements and bulk charges from incumbent to incumbent water company.</p>
<p>2. One respondent proposed that Ofwat should also develop and publish charging rules for bulk charges, as they will lower the likelihood of future disputes.</p>	<p>2. We also anticipate issuing charging rules on bulk services in the future, but this is unlikely to happen before all the relevant changes made by WA14 are fully in force.</p>
<p>3. One respondent suggested that the guidance should focus more on end-customers, as the provision of services to developers can be managed through "connection charges".</p>	<p>3. The guidance sets forth a wholesale-minus approach to calculate bulk charges. NAVs provide services to developers and end-customers and bulk charges are the largest cost for most NAVs. Charging Rules for connection services play an important role but by themselves do not provide a level playing field between NAVs and</p>

	<p>incumbent companies when competing for developers. End-customers supplied by NAVs are protected by the “no-worse” off principle.</p>
<p>4. One respondent suggested whether it would be possible to pass-on more benefits to consumers, arguing that there is nothing in the guidance that ensures that a NAV, as a monopoly, will pass-on any benefits to consumers.</p>	<p>4. Bidding and competition to serve a developer may lead to benefits for consumers, such as better services and often, at least initially, discounts on the local incumbent water companies tariffs, efficiencies arising from multi-utility services provision, innovative solutions and dynamic efficiencies triggered by incumbent companies’ reactions to NAV entry through both effective and potential competition. We are separately reviewing our policy towards NAVs, including our regulation of them, and will consider this point in that review</p>

## Our Decision

We have concluded that the purpose, scope and objectives of our guidance were appropriate.

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

In Section 3 of our consultation document we provided an assessment of two main approaches to setting bulk charges: cost-plus and wholesale-minus. On the basis of that high level assessment we reached a preliminary conclusion that a wholesale-

minus approach, such as the one described in detail in Section 4 of our consultation document would be preferable.

Most of the respondents agreed with our conclusion in favor of a wholesale-minus approach, some of them explicitly stating that they agreed with our assessment of wholesale-minus vs. the cost-plus option. Some of the respondents also considered the wholesale-minus approach to be simpler and less time and resource consuming.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
<p>1. One respondent argued that the numeric illustrative example we provided to show why a cost-plus approach distorts entry vis-à-vis a wholesale-minus approach assumes that a NAV would make zero profits.</p>	<p>1. The example assumed that a NAV would earn a normal (i.e. not excessive) profit.</p>
<p>2. One respondent considered that the cost-plus approach is not linked to cherry picking, as incumbents already have an advantage on low-cost sites due to the application of the “relevant deficit formula” and low cost developments have a small share on new housing developments.</p>	<p>2. Inefficient entry is more likely to occur under a cost-plus than a wholesale-minus, irrespective of the advantages incumbents may have vis-à-vis NAVs.</p>

## **Our decision**

We have reached the conclusion that the wholesale-minus approach remains preferable.

**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.**

In Section 3 of our consultation document we provisionally concluded that a wholesale-minus approach would be preferable. We discussed two broad approaches as to whose costs should be deducted from the relevant starting point: (i) the incumbent water companies’ costs; or (ii) the costs of a reasonably efficient benchmark. However, we left the choice open.

Most respondents favored using the incumbent water company’s costs, although NAVs – a small percentage of total responses – generally favoured a reasonably efficient operator benchmark.

The main arguments provided by respondents in favor of using the incumbent water company’s costs were the following: it is grounded on “well established” economic principles; it ensures the right incentives for efficient entry and dynamic efficiencies; using a reasonably efficient benchmark would be more complex; there is uncertainty regarding the dynamic efficiencies arising from using a reasonably efficient benchmark; and using the incumbent water company’s costs promotes transparency and practicality.

The main arguments provided by respondents in favour of using a reasonably efficient benchmark were the following: it is a more prudent approach and more aligned with allowing competition from small providers; using the incumbent water company’s costs may be difficult to challenge; incumbent water companies lack relevant cost information regarding NAV sites; there are potential long term benefits in using a reasonably efficient benchmark; NAVs are incapable of replicating the scale economies of incumbent water companies.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
1. One respondent considered that it could be difficult to challenge the incumbent water company’s cost	1. Incumbent water companies should put forth credible evidence regarding their cost estimates and could be

<p>estimates used under a wholesale-minus approach.</p>	<p>challenged. We can consider the need for any further obligations on incumbents to disclose information as part of the process of developing any charging rules.</p>
<p>2. One respondent argued that using the incumbent water company's costs posed several problems. First, there is no established cost data for new developments. Second, some costs relate to services which are not core services offered by incumbent water companies (for instance, the provision of on-site non-potable water).</p>	<p>2. One reasonable starting point could be to use the historical cost of the incumbent water company. In cases where the incumbent water company does not provide such services, we expect NAVs to benefit in various ways. For instance, in the case of on-site non potable water, it could be considered a by-product of waste water treatment and, hence, a cost saving. Moreover, the developer will be willing to pay more for this specific service as it increases the value of the property.</p>
<p>3. One respondent considered that a NAV cannot instantly replicate the economies of scale enjoyed by incumbent water companies.</p>	<p>3. We have not seen evidence and do not consider that incumbent water companies enjoy significant economies of scale and/or scope over NAVs in retail plus on-site maintenance.</p>

## Our decision

In the consultation, we left it open whose costs to use.

Deducting the incumbent water company's costs would ensure that only undertakings as efficient as the incumbent water company could enter and make a sufficient margin. However, we also recognized that under some circumstances, this approach may not lead to optimal outcomes, as there may be instances where end-

customers and developers benefit in the long run from the entry of NAVs even when this may not be statically efficient in the short run. This could be the case when NAVs either grow in scale and scope over time or when competition can spur incumbent providers to experiment with more innovative solutions.

Scale and scope economies are important factors when considering whether or not opting for a reasonably efficient benchmark. In the NAV market, on-site economies of scale in ongoing and maintenance costs do not appear particularly important. Critically we do not believe that the incumbent water companies and NAVs' ongoing operating and maintenance costs would be significantly different.

Lastly, the use of incumbent water companies' costs offers some certainty (i.e. incumbents can be expected to know their own costs).

For the above reasons, in our final guidance we have decided to use the incumbent water company's costs.

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

In Section 4 of our consultation document we included a proposal on how the wholesale-minus approach should be implemented. We proposed to use the relevant wholesale tariff(s) as the starting point from which costs are deducted. These covered two main categories: the on-site ongoing costs and the Weighted Average Cost of Capital (WACC) on on-site assets.

Most of the respondents agreed with the proposed overall approach to setting bulk charges.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
1. One respondent considered that the guidance should be supported by detailed "prescriptive" rules.	1. Our guidance indicates how we will approach future determinations and offers guidance for incumbent water companies when setting their bulk charges and NAVs when assessing

	<p>those charges. This guidance needs to apply to different circumstances. Therefore, there is a trade-off between the level of detail and its applicability and practicality. We may publish charging rules in the area of bulk supplies if considered appropriate and when all the regulatory requirements have been fulfilled for us to do so. However, for the same reasons, our normal approach to charging rules is for them to be principle based and not prescriptive.</p>
<p>2. One respondent questioned including the WACC on on-site assets, arguing that in its region assets are wholly funded up-front by the developer.</p>	<p>2. According to our current understanding and information, most incumbent water companies contribute, at least to some extent, to the funding of on-site assets. To the extent that this results in on-site assets accruing to the incumbent water companies' RCV we consider that the WACC should be applied.</p>
<p>3. One respondent argued that creating an overall weighted average tariff would be difficult to reconcile with other proposals in the consultation, such as the production of standardised charges.</p>	<p>3. We consider that there is no conflict or inconsistency between having an overall weighted average tariff and establishing charges which are relatively standardised for practical purpose. In our final guidance we explain that incumbent water companies could either publish charges for each element a bulk supply tariff is made of, or overall charges for sites with different features.</p>

<p>4. One respondent argued that the new incentive/penalty regime will interact with what a NAV can charge their end-customers, arguing that NAVs should not be penalised for incumbents' bad performance.</p>	<p>4. We are separately reviewing our policy towards NAVs and will consider this point in that review.</p>
<p>5. One respondent argued that it might be the case that not all relevant costs have been unbundled to ensure adequate wholesale tariffs. In particular, the respondent indicated that domestic wholesale tariffs had only been recently developed without having been challenged.</p>	<p>5. There are both non-household wholesale tariffs and domestic wholesale tariffs. The respondent has not provided any argument or evidence challenging current wholesale tariffs and showing that these tariffs may have been inadequately unbundled. In any event, this does not lead us to reconsider our approach as the issue is more about whether the underlying data and information are correct.</p>
<p>6. One respondent considered that additional on-site and off-site assets that NAVs own and operate must be considered. In some cases, these additional assets – such as long off-site trunk water mains, rising sewers connecting to incumbents points of connection, or water pumping stations - can be significant and costly to maintain, so an allowance is necessary.</p>	<p>6. The costs to be deducted from the wholesale charges should be those that the incumbent would avoid if the NAV operated the site. In our final guidance we explicitly mention two main categories of costs: on-site ongoing costs and the WACC. The former is a broad category which may include different costs depending on the specificities of each site. However, if NAVs incurred additional costs in order to provide additional services to its own customers – i.e. recycling facilities to provide untreated water etc. – we do not see the basis why these costs should be deducted.</p>

<p>7. One respondent expressed the concern that our consultation could be promoting competition based on potential benefits that may not be delivered, without sufficient regard to inefficiencies. In addition, the respondent suggested that our consultation document did not distinguish between the impact on static and dynamic efficiency when quantitatively assessing incentives to entry decisions under different approaches</p>	<p>7. The consultation emphasises that efficient entry brings benefits both in terms of static efficiency and dynamic efficiency. The example used to illustrate the effects of the wholesale-minus and cost-plus approaches takes into account both static and dynamic efficiency. The illustrative example in our consultation document illustrates issues that would apply either to (i) a static efficiency scenario or (ii) a static and dynamic efficiency scenario, as the relevant factor is whether on-site costs are adequately incorporated when calculating the margin.</p>
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## **Our decision**

We have concluded that a wholesale-minus approach to setting bulk charges is appropriate.

## **Q6 Do you agree with our proposed relevant starting point?**

In Section 4 of our consultation document we proposed as the relevant starting point of the wholesale-minus approach the set of the incumbent water company's wholesale tariff(s) that reflects the NAV's potential end-customer base. This required creating an overall weighted average tariff that would reflect the combined wholesale charges of all the NAV's customers.

Most of the respondents agreed with the relevant starting point we proposed.

<b>Main Issues raised by respondents</b>	<b>Our considerations</b>
<p>1. Some respondents raised concerns regarding the practicality of using an overall weighted average tariff:</p> <ul style="list-style-type: none"> <li>• Calculating an overall weighted average tariff could be quite onerous in terms of time and other resources.</li> <li>• The approach would be dependent on information about the end-customer base that incumbent water companies lack. Therefore, it might increase administration and data collection costs.</li> <li>• It would require the developers and/or NAVs to provide information on the composition of the end-customer base of the site.</li> <li>• As the end-customer base changes through time, regular updates would be needed to reflect changes in the composition of the end-customer base and bulk charges might have to be renegotiated and recalculated until the site is fully occupied.</li> </ul> <p>Some respondents proposed using default bulk charges for housing developments - as NAV sites</p>	<p>1. Adjusting bulk charges to the end-customer base may entail some costs, but the benefits are creating bulk charges that reflect the end-customer base and enable a well-functioning market. Overall, we consider that an overall weighted average tariff is practical.</p> <p>Information regarding the composition of the end-customer base is available from different sources (NAVs, developers or planning documents)<sup>5</sup>. Incumbents may publish tariffs for different types of developments or, alternatively, a set of tariff elements (price per type of premise, service or length of main, etc.) and a pricing formula, so NAVs are able to anticipate the charge for bulk supply services. These approaches can be used in most sites. Parties can agree to apply those inputs and formulas to the end-customer base they consider.</p> <p>If the end-customer base changes, adjustments would be required. These adjustments would not entail re-negotiations in a proper sense, but recalculations of the bulk charge based</p>

<sup>5</sup> There is usually information regarding the customer base. Most of the respondents have not seen this as a problem. In case they deemed average tariffs problematic, the main concern relates to adjustment costs - i.e. the cost of adjusting given new information - not the information in itself. NAVs can provide incumbents with information regarding the customer base.

<p>predominantly refer to housing sites - and making “corrections” when NAV sites refer to non-housing developments. In a similar fashion, other respondents also proposed using default bulk charges - either residential or non-residential - and leaving the overall weighted average tariff for exceptional cases<sup>4</sup>. To lower information requirements on the mix of end-customers in the site, one respondent advocated using the principal occupancy type of the site as the basis of the tariff.</p>	<p>on the standardized charges applied to an updated end-customer base.</p> <p>Default tariffs are possible within this framework. In particular, it is possible that parties agree to treat a mixed site “as if” it were a non-mixed site. For instance, in the case a relevant proportion of the site is either a housing or commercial development to a certain extent (for instance, 80% or more), they can treat the site “as if” it were either only housing or commercial. So the default tariff approach would be available if parties agree to it, even in a framework where it is also possible to build overall weighted average tariffs through pricing formulas and price components.</p>
<p>2. One respondent suggested that the bulk supply agreement should be reviewed every 5 years, in line with Ofwat’s Price Reviews.</p>	<p>2. We consider that incumbent water companies should update their bulk supply charges when elements of the wholesale-minus change, such as for example when the wholesale charge changes. When changes relate to information held by NAVs – i.e. the customer base composition – we expect NAVs to inform and request a change from the incumbent water company.</p>

<sup>4</sup> For example, if a development is over 80% either commercial or residential, then no overall weighted average tariff would apply.

<p>3. One respondent indicated that its wholesale charges do not differ across types of end-customers. Therefore, there is no need to create an overall weighted average tariff.</p>	<p>3. This would be a special case, in the sense that an overall weighted average would lead to the same result as a non-weighted average because wholesale tariffs do not differ across types of consumers. The general case however is that wholesale tariffs differ. Hence, using an overall weighted average seems a reasonable approach. In the case mentioned the bulk supply charges to be published would be simpler.</p>
<p>4. One respondent observed that the guidance does not specify the volumes to which the overall weighted average tariff would apply - either supplied or consumed volumes. The respondent suggested that using supplied volumes could be an option, as it would be more practical and would incentivise NAVs to limit leakage.</p>	<p>4. We consider that both options are possible and their feasibility depends on whether there is a boundary meter. In the consumption option mentioned by the respondent leakage must be factored in setting the bulk supply charge.</p>
<p>5. One respondent observed that the example provided in our consultation document does not take into account the relevant volumes of water/wastewater that are consumed/discharged by the mix of customers.</p>	<p>5. The example is just a simple illustration to show how the overall weighted approach works. The wholesale-minus approach is also applicable to a water/wastewater scenario.</p>
<p>6. One respondent argued that wholesale tariffs have only been calculated for the non-household sector, although NAV sites are mostly residential.</p>	<p>6. There are wholesale tariffs for household customers for compliance issues which can be readily used when applying the wholesale-minus approach</p>

	to residential customers in new developments.
7. One respondent casted doubts on whether wholesale tariffs can be used as a valid starting point, without knowing the costs which have been excluded, how these costs were calculated and whether incumbents have applied a consistent approach. The respondent suggested that wholesale tariffs should appropriately allocate non-direct retail costs (such as bad debt, premises costs, management costs and other corporate costs) along with direct retail costs.	7. The respondent does not provide further arguments or evidence regarding the claim that wholesale tariffs might not be an adequate starting point. As regards to the cost allocation proposal, bad debt is already included in the retail margin and the allocation of costs between retail and wholesale activities is outside the scope of setting bulk supply charges.
8. One respondent indicated that while incumbents charge a Value Added Tax (VAT) in the bulk supply, retail tariffs do not incorporate VAT. Therefore, this could lead to a discrepancy between the costs faced by incumbents and the costs faced by NAVs.	8. VAT on bulk supplies can be recovered through the HMRC as any other VAT imposed on other inputs that the NAV needs to provide services.

## Our decision

We have concluded that the relevant starting point should be the overall weighted average tariff(s).

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

In Section 4 of our consultation document we considered that the first set of costs that should be deducted from the relevant starting point related to the on-site ongoing costs of operating and maintaining the on-site assets. In our consultation document, we left open whether the costs to be deducted should be those of the incumbent water company or those of a reasonably efficient benchmark.

Most of the respondents agreed with our definition and approach to estimate the ongoing on-site costs.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
<p>1. One respondent discussed two ways to estimate on-site ongoing costs: average maintenance costs and what it labelled as “contemporary” costs. It indicated a preference for a “contemporary costs” approach, as these costs provide more certainty and may mitigate the likelihood of inefficient entry. If average maintenance costs were chosen, it suggested that it would be important to use the costs over the lifetime of new assets. The respondent also argued that these costs could be significantly lower relative the costs of older assets, as technological progress has increased resilience.</p>	<p>1. The respondent did not fully explain what it meant when referring to a “contemporary costs” approach. If an average maintenance costs approach over the lifetime of the assets is used, payments could take the form of an annuity. Equal payments overtime that are equivalent in net present value terms to the net present value of all the costs incurred of different amount and at different times over the lifetime of the asset. Because of the present value equivalence, we do not consider that the suggested approach could lead to inefficient entry.</p> <p>The claims arguing that new assets have lower costs over their lifetime than older assets due to technological</p>

	<p>progress should be supported by hard evidence, which has not been submitted.</p>
<p>2. One respondent argued that estimating lifetime costs would require a definition of the standard life of infrastructure assets. If the aim is to apply consistent discounts across the industry, it would be advisable to have an industry average. The data for obtaining this figure should be centrally collated and independently issued so as to maximize consistency and minimize the regulatory burden on companies.</p>	<p>2. We consider that incumbent water companies should make their own estimates of costs as these may differ and vary geographically and across companies.</p>
<p>3. One respondent observed that using a valuation of the incumbent water company's on-site costs is a pragmatic way forward. However, it will provide NAVs with a temporary advantage: pricing will include discounts based on the maintenance costs of mature assets, while NAVs' expenditures may be lower because new assets require less maintenance. The respondent suggested that this could justify a discount on the WACC.</p>	<p>3. An approach that covers the lifetime ongoing costs of the onsite assets and converts them into an annuity would not provide NAVs with an advantage. A NAV should be indifferent between the actual pattern of cost and an annuity value. Hence, we do not consider it appropriate to adjust the WACC as suggested by the respondent.</p>
<p>4. One respondent argued that the bulk charge should make an allowance for NAVs' operating and maintenance costs, including managing leakage, repairing, testing and meter replacement as well as any associated regulatory or reporting requirements.</p>	<p>4. The relevant costs to be discounted should be restricted to the costs which are avoided by the incumbent water company. In addition, it is not clear whether there should be an allowance for the avoided regulatory costs as these tend to be large and lumpy and not</p>

<p>In addition, it suggested that the guidance should take into account the positive effect that, for various reasons, a NAV providing a site may have on the incumbent water company's income:</p> <ul style="list-style-type: none"> <li>• The incumbent water company will make a lower bad debt provision.</li> <li>• The incumbent water company will obtain more income as a result of on-site leakage being chargeable to the NAV.</li> <li>• Other "benefits" that NAVs provide to incumbent water companies. For instance, technological investments that reduce demand (i.e. a non-potable water demand system). These investments reduce peak and average demand, and the resources and capacity allocated to the site.</li> </ul>	<p>attributable to a specific set of customers.</p> <p>Regarding the factors leading to an increase in the incumbent water company's income if NAVs operate the site, we consider that:</p> <ul style="list-style-type: none"> <li>• Bad debt is included in the retail margin, hence by starting at the wholesale tariff bad debt costs would already be removed from the bulk supply charges.</li> <li>• To the extent that the wholesale charge(s) were set on the basis of estimated leakage across the entire distribution network, the incumbent water companies would not incur any leakage costs that occurred in the on-site infrastructure. Therefore, NAVs should not pay for these costs and an appropriate allowance should be made in the bulk supply charge.</li> <li>• In relation to the benefits that NAVs may provide to incumbent water companies – for instance, through the installation of water saving technologies – these would relate to how wholesale charges are designed and should not be addressed by bulk charges. Well designed, cost-based wholesale charges should reflect the savings that NAVs may trigger for incumbents – i.e. due, for instance, to water saving technologies. Some incumbent water companies already take this into account for their infrastructure charges. Moreover, this</li> </ul>
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	<p>type of innovations should add value to the development in the form of cheaper bills to end-customers, increasing property prices and, thus, leading to higher developers' bids for the services provided by NAVs.</p>
<p>5. One respondent argued that on-site costs will be different from the average costs for the remainder of an incumbent water company's network, which is comprised of "legacy assets". In addition, new developments are built with modern materials that have low initial costs. For instance, leakage is likely to be very low.</p>	<p>5. Initially, ongoing costs in new sites will differ from costs in later stages, at the end of the life of the asset. However, to claim that there is a difference in costs with older assets - along the lifetime of the asset – because these assets are newer, evidence should be provided. No evidence has been provided on this.</p>

## Our decision

We have concluded that our definition and approach to estimate the ongoing on-site costs remain adequate. In line with our decision on the wholesale-minus approach, the costs to be deducted are those of the incumbent water company.

### **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 Section 4 of our consultation document we considered that the second set of costs that should be deducted from the relevant starting point relate to the WACC on the on-site assets. In our consultation document we left it open whether the incumbent's WACC should be adjusted taking into account two factors: (i) the effect of the regulatory protections that incumbent water companies enjoy and (ii) the fact that the relevant risk relates to the investment in the site and not to the incumbent water company's entire regulated (and often unregulated) business.

Only a minority of respondents – most of them NAVs - stated that there needs to be an adjustment to the WACC. These respondents generally propose using some simplified mark-up over the incumbent water company’s WACC across all its sites.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
<p>1. One respondent expressed concerns on whether the WACC should be adjusted, as Ofwat's temporary recent arrangements require incumbents to “pay” an income offset to NAVs. If the incumbent “pays” for the NAV’s on-site assets, NAVs should not earn a return.</p> <p>A higher WACC for a NAV could be justified if NAVs experienced a higher undiversifiable risk, but more evidence is needed to determine if this is the case.</p>	<p>1. Recent changes in the income offset regime ensure that NAVs compete on a level playing field with their competitors.</p> <p>Section 3 and Annex 2 of our final guidance explain why and how the incumbent water company’s WACC should be adjusted. There we said that to the extent that the incumbent water company accrued the on-site assets to its RCV, if it undertook the development instead of a NAV, the WACC should be applied to the same type and value of assets.</p>
<p>2. One respondent suggested that if the guidance opted for the incumbent water company’s WACC as a benchmark, then the adjusted WACC should be lower than the “average market cost of capital”, because NAVs’ exposure to risk is lower than for the average market. In addition, the WACC should not be set so as to encourage inefficient entry and distort competition between NAVs and SLOs.</p>	<p>2. The respondent’s proposal does not define what the “average market cost of capital” is and how it is constructed. It also does neither explain nor justify why a "NAV has limited exposure to risk compared to the average market".</p>

<p>3. One respondent disagreed with the assumption that NAVs and incumbent water companies enjoy a different regulatory status and therefore disagreed that the WACC should be adjusted on these grounds. It favored using the WACC determined by Ofwat at price reviews.</p>	<p>3. Section 3 and Annex 2 of our final guidance explain why and how the incumbent water company's WACC should be adjusted.</p>
<p>4. One respondent argued that on-site works will be paid "in full" by developers from 2020. In addition, infrastructure maintenance has traditionally been funded on a pay-as-you-go basis through customer bills. Hence, the total amount of capital earning a return should be lower than the "costs of construction".</p>	<p>4. Currently, the incumbent water companies contribute to funding the on-site assets and earn a return on their contribution. Our approach was highlighted under point 1 above. The maintenance costs of the on-site infrastructure are on-site ongoing costs that should be deducted from the wholesale charges.</p>
<p>5. One respondent expressed concerns that adjusting the WACC could lead to higher bills for NAVs' consumers.</p>	<p>5. The "no-worse" off principle ensures that the NAV's end-customers will not be worse than with the incumbent water company.</p>

## Our decision

We have decided that the incumbent water company's WACC should be adjusted according to the factors specified in Section 3 and Annex 2 of our final guidance.

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

Respondents made different suggestions on how to estimate the appropriate WACC.

<b>Main Issues raised by respondents</b>	<b>Our considerations</b>
<p>1. One respondent suggested that the WACC adjustment should take into account the different risk profile between NAVs and incumbents. To calculate this risk differential, it proposed to make a reference to the WACC or equivalent metric used in the “financial press/agencies” for the market category of NAVs.</p>	<p>1. The proposal was not clearly argued and sufficiently justified. The adjustment needed may not be equivalent to the difference between the NAV industry WACC and the regulated WACC, as proposed by the respondent. We are not seeking to establish the appropriate WACC for NAVs. Instead, we are adjusting the incumbent water companies’ WACC to remove regulatory advantages that NAVs would not enjoy and tailor the risk and returns to the activities concerned.</p>
<p>2. One respondent proposed to calculate an average of a selection of published WACC of both incumbent water companies and high risk companies from a regulated market, such as telecommunications.</p>	<p>2. The proposal was not sufficiently justified. It is unclear how this would address the concern about incumbent water companies enjoying regulatory protection and why averaging both groups of the proposed selected companies would be the right approach. Furthermore, it is unclear how this would define the appropriate risk profile for running and maintaining on-site businesses.</p>

<p>3. One respondent argued that unless NAVs face a higher undiversifiable risk, an adjusted WACC would provide them with an unjustified advantage.</p>	<p>3. Regulatory protections provide incumbent water companies with a regulatory advantage which is not the result of competition on the merits. Efficient NAVs would not enjoy this protection.</p>
<p>4. One respondent suggested that if Ofwat considered necessary to apply a mark-up on the incumbent water company's WACC then this figure should be included in our final guidance.</p>	<p>4. We agree and have included a figure in Annex 2 of our final guidance for the remainder of PR14.</p>
<p>5. One respondent considered that the adjustment on the WACC should take into account that incumbent water companies' ongoing costs are higher due to the higher maturity of their assets.</p>	<p>5. An approach that covers the lifetime ongoing costs of the onsite assets and transforms them into an annuity would not provide a NAV with an advantage. A NAV should be indifferent between the actual pattern of cost and an annuity value. Hence, we do not consider appropriate to adjust the WACC as suggested by the respondent.</p>
<p>6. One respondent proposed to adjust the WACC using a midway figure between a benchmark WACC for incumbent water companies and a benchmark WACC for NAVs.</p>	<p>6. It is unclear why the WACC should be set mid-way in the proposed fashion.</p>

<p>7. One respondent argued that the WACC of a project is a function of the intrinsic characteristics of the project, not a function of the entity seeking finance. Consequently, “regulatory protections” are a separate consideration of that project’s cost of capital. In addition, the respondent added that this issue might not be very important, because in general NAVs do not invest anything. It is the developer who invests and provides for the assets - or pays them in full. If there is not an up-front investment, then there are no assets on which to ensure a return.</p>	<p>7. The cost of capital of an entity seeking finance for a given project is affected by many factors. We are not seeking to equalize the risk for incumbent water companies and NAVs other than factors that are the result of the regulatory approach. On the second point, to the extent that the incumbent water company accrued the on-site assets to its RCV, if it undertook the development instead of a NAV, the WACC should be applied to the same type and value of assets.</p>
<p>8. Some respondents argued that incumbent water companies do not enjoy a regulatory protection compared to NAVs, in particular regarding volume risks. In addition, one respondent suggested that Ofwat seems to be proposing that NAVs should have a higher WACC due to their size.</p>	<p>8. Incumbent water companies’ WACC reflects the advantage provided by regulatory protections, amongst other factors. As explained in Section 3 and Annex 2 of our final guidance, incumbent water companies are more protected against demand risks than NAVs. Pure differences in size do not justify an adjustment on the WACC.</p>
<p>9. One respondent argued that Ofwat has not made an adjustment on the WACC in the case of upstream resources or bio-resources. Hence, the same approach should be applied in the case of “the downstream market for new connections”.</p>	<p>9. Differences between sectors may justify different approaches. For instance, in the bio-resources sector, regulatory protections against volume risks are not as relevant as in the NAV market.</p>

## Our decision

We have decided that the incumbent water company's WACC should be adjusted according to the factors specified in Section 3 and Annex 2 of our final guidance.

### **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.**

Only a minority of respondents explicitly suggested to take into account other costs.

<b>Main Issues raised by respondents</b>	<b>Our considerations</b>
<p>1. One respondent suggested that wholesale costs associated with the organisation of the business retail market should be deducted from the relevant wholesale tariff(s). The reason being that NAVs do not contribute to these costs.</p>	<p>1. Who pays the costs for setting up the market operator is, in principle, unrelated to the supply of bulks services.</p>
<p>2. One respondent indicated that more clarity is need regarding how Ofwat considers the income offset should be treated in Wales.</p>	<p>2. We have reformed the treatment of the income offset in England. We are planning to consider the income offset issue in Wales as part of issuing Charging Rules on Welsh new connections. We will have the powers to do so from 1 April 2019. In the meantime, the way the income offset is treated in Wales will remain unchanged.</p>

<p>3. One respondent suggested other costs which should be taken into account:</p> <ul style="list-style-type: none"> <li>• NAVs generate retailing-type costs for the incumbent water company, such as meter reading or boundary meter management and replacement. Incumbent water companies should be allowed to recover these costs. The suggestion is, therefore, that these costs should be added rather than deducted to the relevant starting point;</li> <li>• NAVs have business costs to recover - such as the costs of running a network operations division - which will need to be included in any wholesale margin. These would be additional costs that should be deducted according to the respondent; and</li> <li>• Rather than including the incumbent water companies' adjusted WACC, an alternative option could be to allow a profit margin on the avoidable operating costs.</li> </ul>	<p>3. On the different concerns raised:</p> <ul style="list-style-type: none"> <li>• Should the installation of a meter be necessary, this a cost that should be borne by the incumbent water company. In the case the NAV provided the site, the costs of meter reading should be deducted from the wholesale tariff(s), as the NAV will undertake the meter reading on-site.</li> <li>• Overhead costs are likely to be fixed costs, so it is not clear whether they have to be taken into account to arrive to the wholesale margin. In other words, these costs would not be avoided by the incumbent water companies; and</li> <li>• As we are concerned about infrastructure investment, an approach based on a WACC and not on a margin on costs seems more adequate.</li> </ul>
<p>4. One respondent argued that mandatory hygiene standards require whoever installs the network to flush the water pipes after installation and before end-customers could receive services. Only the NAV is charged for this water, "as the incumbent [water company]</p>	<p>4. In the case where incumbent water companies recover the cost related to flushing the water pipes from developers, it should not be deducted from the relevant wholesale tariff(s). If, instead, incumbent water companies</p>

<p>insists on a site boundary meter/s". As there is no resident or developer to charge to offset the cost, the NAV has to bear the charge. This should be considered in setting the bulk charge.</p> <p>There are also some customer facing costs that should be deducted. Only some of these are recovered under the retail element of the charges. Hence, others should be deducted from the incumbent water company's wholesale tariff.</p>	<p>recovered it from end-customers, then it should be deducted.</p> <p>The concern regarding customer facing costs relates to how retail costs have been estimated. In principle, this is unrelated to the approach to setting bulk charges.</p>
<p>5. Emergency services are likely to be higher for NAVs, as they do not benefit as much from end-customer geographical density. In addition, incumbent water companies buy meters at a lower price, because they have more buying power.</p>	<p>5. Incumbents may have a cost advantage for both emergency services and meter purchasing/installation. However, these could be considered as services where the incumbent is more efficient. Hence, NAVs could chose to self-supply if more efficient, in which case the cost that the incumbent would avoid should be deducted from the relevant starting point.</p>

## Our decision

We have concluded that broadly speaking the main categories of costs to be taken into account are adequate.

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

In Section 4 of our consultation document we considered that our proposed approach was sufficiently flexible to be adapted to changes to the existing circumstances.

Most of the respondents considered our proposed approach sufficiently flexible.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
1. One respondent suggested a periodic review to assess whether the outcomes anticipated by the guidance have actually been delivered.	1. Like all guidance this guidance may need to be updated in the future to reflect the experience. Establishing a periodic review now does not seem appropriate. It would be best to do so if and when there is sufficient evidence justifying a change.
2. Some respondents were concerned about a possible retroactive effect of the guidance.	2. As we said in our consultation document, the guidance “would not have retrospective effect – i.e. it will only apply to agreements that are referred to us for a determination after the date when this guidance is finalised”.

## **Our decision**

Our conclusion is that the guidance offers sufficient flexibility of our approach.

**Q12 Do you consider that it would be possible to standardize charges under many if not most circumstances? Can you specify the circumstances where this may not be possible?**

In Section 4 of our consultation document we considered that it was possible and appropriate to set bulk charges that catered separately for a standardised set of bulk services. We also understood that, for a, potentially limited, number of sites with specific and non-standardisable requirements, the incumbent water companies' bulk charges would need to reflect the specific features of the site and the needs of the NAV. Therefore, some bulk charges might need to be bespoke.

Most of the respondents agree with the possibility to standardise charges under many if not most circumstances.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
<p>1. Some respondents argued that it would be feasible to publish the pricing formula and the pricing inputs, but not the charges for different sites.</p>	<p>1. In our consultation document we did not intend to exclude a form of standardization based on using a pricing formula and the pricing inputs, so that NAVs can tailor or predict the bulk charges for a specific site.</p>
<p>2. One respondent argued that 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 decisions.</p>	<p>2. Standardization does not entail homogenization. We consider that standardization is possible for a majority of sites, either through the publication of charges for specific types of sites or the pricing formula and the pricing inputs.</p>

## **Our decision**

In section 3 of our final guidance we have clarified our position on the possibility of standardised charges for bulk services, explicitly allowing for charges covering each

element a bulk supply tariff is made of or specific charges for a set of sites with different features.

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

In Section 4 of our consultation document we considered that there were benefits from incumbent water companies publishing relevant charging information.

Most of the respondents agreed with our proposal for the provision of tariff information.

<b>Main issues raised by respondents</b>	<b>Our considerations</b>
<p>1. One respondent suggested that the proposal for the provision of tariff information could lead to an increase in the “regulatory burden”.</p>	<p>1. We consider that transparency has critical benefits in ensuring that markets function well and bring benefits to end-customers and developers. In addition, more transparency and predictability will lower transaction costs.</p>
<p>2. One respondent was concerned that any expectation to publish bulk charges without charging rules in place will lead to a variety of different approaches and be more confusing for NAVs.</p>	<p>2. We consider that it may be appropriate to issue charging rules. However, the current lack of transparency is a concern and also confusing for NAVs.</p>

### **Our decision**

In section 3 of our final guidance we have clarified our position on the provision of tariff information.



## **Annex 1 – List of respondents to the consultation**

### **New appointees and variations**

- Albion Water
- SSE Water
- Independent Water Networks
- Icosa Water
- Leep Water Networks
- Severn Trent Connect (a part of Severn Trent)
- [CONFIDENTIAL respondent]

### **Water and sewerage companies**

- South East Water
- South Staffordshire Water
- South West Water
- Thames Water
- United Utilities
- Welsh Water
- Wessex Water
- Yorkshire Water
- Affinity Water
- Anglian Water

- Bristol Water
- Northumbrian Water
- Severn Trent Water
- Portsmouth Water

### **Other**

- Welsh Government
- Consumer Council for Water

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gsi.gov.uk](mailto:mailbox@ofwat.gsi.gov.uk)

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