Via email: NAVPolicy@ofwat.gov.uk

NAV Policy
Ofwat
Centre City Tower
7 Hill St
Birmingham
B5 4UA

15th September 2020

Dear Sir,

Consultation on Bulk Charges for New Appointments and Variations

We welcome Ofwat's consultation on bulk charges for NAVs and the accompanying CEPA study. We have found the reports useful and ahead of publication of charges for 2021/22, we intend to make full use of the best practice highlighted in the CEPA report to modify our approach and raise our performance. This work will also include introducing changes resulting from amendments to Ofwat's guidance after this consultation.

On this latter point, we note that Ofwat intends to issue new guidance in December 2020, for implementation in charges from 1st April 2021. We think this is a very tight timescale. This is because our Board meet in early January to approve proposed charges, so if guidance is available only in December, it gives very little time to implement changes and achieve assurance and Board approval. December is already a very busy time with work to set and assure wholesale, retail, new connection and non-primary wholesale charges. Therefore, we would ask Ofwat to consider accelerating its timetable, perhaps publishing revised guidance by end of October 2020 to give companies time to assimilate changes to guidance in their NAV charges publications.

We have set out our views on the specific questions in the consultation in the attachment.

Yours faithfully

Martin Hall
Senior Regulatory Economist

Consultation on Bulk Charges for New Appointments and Variations

Q1: Do you agree with our proposed approach to weighted average tariffs?

We already set our weighted average tariff based on the 'menu-based' approach, using the actual numbers and types of properties served by each NAV within our area. We are not opposed to the ex-ante method, but conclude that there are advantages to the accuracy of charges, and consistency across the country if all companies used the 'menu-based' method. Therefore we support Ofwat's proposed approach on this matter.

Q2: Do you agree that large user tariffs should not be offered for new NAV sites? What should the approach be to existing sites?

We do not offer large user tariffs to new NAV sites and consider the May 2018 guidance to have been clear that the relevant starting point for the wholesale minus approach should be the weighted average of the published wholesale tariffs that would have been applicable to the end customers had the incumbent made the supply, rather than the NAV. For the majority of NAV sites, which comprise new housing and small to moderately sized business customers, we do not see how offering the large user tariff can be consistent with the guidance, so we agree that this practice should not continue.

As far as we can see, the only time that the large user tariff should be used in determining the relevant starting point, is the case where the end customer(s) would have qualified for the large user tariff in their own right, according to the rules on eligibility for large user tariff set out in each company's charges scheme.

Some companies may have NAVs with prices that were agreed prior to the May 2018 guidance – legacy NAVs - and that may be the reason that they continue to offer the large user tariff. We were in a position with legacy tariffs, but we have made transition in our charges to meet the requirements of the May 2018 guidance, so we think other incumbents should be able to do the same.

Q3: Do you agree that incumbents should use bottom-up approaches to estimate costs, or would more granular accounting segmentation be more appropriate?

We note that CEPA have not concluded on whether a bottom-up, or granular accounting separation approach is superior and both have potential drawbacks.

The granular approach whilst increasing the regulatory reporting burden, provides greater transparency and would allow for convergence in companies' methodologies. Therefore, it would be expected to reduce the variations in margin observed by CEPA where these result from different methodologies, so that in future, variations in margin predominantly reflected cost differences.

The bottom-up approach is we think, more complex as it appears to require a detailed assessment of avoided costs, considering the assets built by NAVs on a site by site basis. Whilst this might produce a certain degree of improvement in cost-reflectivity, it would not aid transparency. It could still allow methodological differences in estimation of bottom-up costs to persist across companies. We also note CEPA's observation in relation to bottom up costs that, it may be '*a suitable approach for determining more bespoke NAV tariffs that vary by region and site characteristics, for example. However, it may be less suitable for determining standard NAV tariffs'*

In our view, the potential benefits to transparency and convergence outweigh the superiority of the bottom-up approach in cost reflectivity, so our preference would be towards the granular accounting segmentation approach.

Q4: Do you agree with CEPA's list of common avoided costs or should additional items be included? Should we incorporate this list in our guidance?

We have reviewed the list of common avoided costs and consider that these all relate to activities that can be avoided by the incumbent as a result of NAVs providing, operating and maintaining local infrastructure. We have found examples in the list of avoided costs that we do not currently include in our wholesale minus calculation, and recognise that we need to update our approach to account for these. We suspect that other incumbent companies will be in similar positions in that they will have reflected some, but not all of the avoided costs listed. Therefore we would support inclusion of the list in future guidance.

Q5: Do you agree with our proposed treatment of indirect costs?

We agree with the proposed treatment that we should take account of indirect costs in our calculation of avoided costs, and as amplified in the CEPA report that only those costs that are avoided (i.e. a portion of the common costs) should be included in the calculation, while no joint costs should be included

The section in the consultation, p16 is rather light and amounts to only the highest level of guidance. In absence of any further detailed guidance, this will leave companies free to devise the techniques they feel most suitable, and this will most likely generate a set of diverse approaches. If this is not the outcome Ofwat desires, then companies will need more detailed guidance and a clearer indication of Ofwat's expectations for how they should approach the estimation of common costs.

Q6: Do you agree with our proposed approach to capital maintenance and replacement expenditure?

As with direct operating costs we note that CEPA have not concluded on whether a bottom-up, or granular accounting separation approach is a superior technique to use for deriving avoided maintenance costs, and both have potential drawbacks. From the consultation, Ofwat prefer the bottom-up approach for the reasons given in section 3.2.1. As in our response to Q3 and for the same reasons given there, we would like Ofwat to consider again the advantages of the granular approach compared to the bottom-up approach.

We do however agree that regardless of which approach is taken to estimate avoided capital maintenance costs, incumbents should reflect these in NAV tariffs as an annuity.

Q7: Do you agree with our proposed approach to the income offset for Welsh incumbents?

As we do not operate in Wales, we do not have strong views. The logic for the adjustment would imply that for as long as Welsh companies continue to offer an income offset, there is, in Wales, a case to continue with the May 2018 return on capital element in avoided costs.

Q8: Do you have other comments on the rate of return with respect to English incumbents?

We agree that the return on capital element of charges should no longer apply as an element in the wholesale minus calculation in England, because both developers, whether self-laid or not, and NAVs now pay 100% of on-site development costs.

We agree with CEPA's finding that NAVs are exposed to operational risks on the networks that they operate, where those risks would otherwise have been borne by incumbents. Therefore, where a NAV is present, the incumbent has avoided an element of operational risk. There is logic then to continue with a rate of return 'operational risk' adjustment within the wholesale minus approach.

We have noted that CEPA has considered different possible approaches to setting the return on operational risk. All seem to have drawbacks and it does not seem straightforward to calculate the return. For this reason we favour the % margin on turnover approach which is simple to apply and a transparent adjustment, although it requires a judgement as to what the appropriate % margin should be.

Q9: Should our guidance explicitly state that bulk charges should not financially penalise NAVs for promoting greater water efficiency?

We agree with the principle that NAVs (or any other party for that matter) should not be financially penalised for accomplishing greater water efficiency, and this is particularly important as we operate in a water stressed area. In addition there should not be incentives for NAVs to increase the volume of water taken (p35 of CEPA's report describes how in some circumstances NAVs may benefit from increasing consumption) so we would welcome statements in guidance that explicitly describe both of these principles.

We think the best way to accomplish the desired outcomes is through the balance of fixed and volumetric charges in NAV tariffs, in particular the greater the volumetric element of the NAV bill, the higher the bill will be if the NAV takes more water, providing incentives towards careful water use.

Q10: Do you agree with the principle that NAVs should have discounted charges if they deliver sustained lower per capita consumption (and similarly improved outcomes with respect to rainwater volumes and sustainable drainage) based on avoided costs or environmental impact mitigated?

We already offer a discount on infrastructure charges for developments that are constructed to meet high water efficiency standards so we have extended economic incentives in new connections. In tariffs, we are not opposed in principle to the idea that low consumption per head customers, who impose lower costs on our wholesale network than average or high demand customers, could pay less. However, we are not convinced that a low per capita consumption tariff is the right tariff design to accomplish this.

This is because to offer discounts based on per capita consumption, it is necessary to establish and maintain reliable occupancy data for each property to be able to calculate per capita consumption. In practice, this is an intensive process because properties have constant changes in occupancy throughout the year (births, deaths, children moving out of home, students leaving and returning from universities, taking in elderly relatives etc). Also, occupancy can change when properties change hands, when a large family moves in to replace an out-moving small family for example, so monitoring occupancy is a continuous undertaking. We think it would impose a significant data collection and assurance burden on NAVs to monitor occupancy - and hence per capita consumption - to demonstrate eligibility for lower tariff. Occupancy dependent tariffs also generate a need to ask

customers about occupancy in their property on a frequent basis, which customers may find bothersome.

As an alternative, consumption might be monitored on a per property basis, which does not require the same information burden as monitoring occupancy. But it would not be right to offer a discount to a NAV based on low per property consumption, if that NAV had low consumption per property simply because its property mix was weighted towards small, apartment dwellings compared to another different NAV whose developments happened to be 4-5 bedroomed executive homes. Therefore low per property consumption tariffs also have difficulties because they do not necessarily take into account property mix and occupancy rates.

A further alternative is to discount NAV tariffs on the basis that within the NAV boundary as a whole, average per capita consumption is lower than the incumbent's average. But this could be driven by a different property mix within the NAV boundary compared to the incumbent's property mix as much as by different customer water use. It also suffers from the free-rider problem in that within the appointment there could be profligate water users, who would benefit from a lower tariff because a sufficient number of their neighbours were careful water users. This does not seem to be a fair outcome either.

We also think that the principle of non-discrimination means that if NAVs are to be offered a lower tariff / discount on the basis that their customers have low per capita consumption, then for non-discrimination compliance, we would need to offer similar terms across our customer base, to individual domestic customers who also had low per capita consumption.

There are then wider implications of offering discounts to NAVs because of the difficulties of reaching an appropriate tariff design plus potential crossovers into other sectors of the customer base. In our view, before proceeding, these need a more careful consideration.

Other points

We think there is an inaccuracy in the CEPA report, in table 4.4, p.40. Affinity Water is company C and our deduction for WACC and depreciation is £0.2365/m3. According to CEPA, for their model NAV development, this results in a deduction of £1,770, but we calculate this to be £13,225 instead (being £0.2365 x 57,500m3 = £13,225). So the CEPA table understates our discount by a factor of 7.5 times.