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BY EMAIL: NAVpolicy@ofwat.gov.uk

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Dear Ofwat

RE: Consultation on bulk charges for New Appointments and Variations (NAVs)

We seek to support the development of markets wherever they deliver long term benefits to customers. We were pleased to see that our strong support for markets, and the developer services market in particular, was highlighted by Ofwat in the recent letter sent to Peter Simpson by Rachel Fletcher following publication of the "Review of incumbent company support for effective markets".

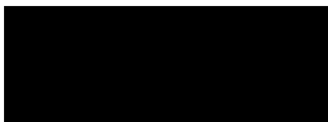
We view NAVs and self-lay providers as valued customers, who together can help in meeting the infrastructure requirements of housing growth in our rapidly growing region. We have been active in the Water UK working group that developed the NAV service level metrics and led the development of the industry standard bulk agreement. This facilitating spirit also informed our approach to tariffs, where we have worked hard to develop NAV tariffs in line with Ofwat's guidance and were again pleased that CEPA's assessment recognised this position.

We consider the CEPA report is a helpful contribution to the ongoing discussion regarding the basis for NAV charging. We have set out in the attached appendix our response to the questions in the consultation document.

Having taken a leading position to date in helping to develop effective processes for the NAV market, we would be keen to be involved in future industry discussions to further advise on and help test the practicalities of implementing further changes to the methodology in calculating bulk charges for NAVs.

Please let me know if you have any questions or require clarification on any on the points made in the appendix.

Yours sincerely



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Director of Strategy and Regulation

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Appendix 1

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

Yes, we agree with a menu-based approach when defining the relevant wholesale tariffs.

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

Yes, we agree that large user tariffs should not be offered for new NAV sites.

Our approach for existing bulk agreements entered into prior to May 2018 is that, until such time as the existing bulk agreement expires, it is for the NAV to decide whether it wishes to move from the existing basis of charging (typically wholesale charges for non-households) to our published NAV Charging Arrangements. Once, and if, it has made the decision to switch to the NAV Charging Arrangements, that will be the basis for charging going forward. On entering a new bulk supply agreement for the site on expiry of the existing agreement, the NAV Charging Arrangements will apply.

We consider that this is a fair approach, giving the NAV certainty on pricing in place at the time it entered into the bulk agreement, and the choice to move to the new arrangements if it considers it appropriate.

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

No, we do not agree that incumbents should use bottom-up approaches to estimate costs. We note that CEPA concludes in section 6.2 of its report that there is not a single preferred method for calculating deductions for avoided direct operating costs. We consider that a more granular segmentation of costs in the annual performance report would be more appropriate, and as noted by CEPA that this has the advantage of creating consistency across the sector if based on a prescribed methodology. If this approach was replicated in the guidance it would allow further transparency to users of the NAV Charging Arrangements.

This approach may capture in the calculation some wider ongoing network costs incurred upstream of the bulk meter e.g. costs relating to pumping stations and service reservoirs, and therefore these "errors of inclusion" would tend to overstate the average expenditure on local NAV-type networks. As a consequence, this may encourage marginally inefficient entry, but by the same token, it allows the more transparent, and efficient, top-down approach to the calculation of the minus.

It should also be noted that it is not correct to assume that in relation to a "bottom-up" approach incumbents should already have detailed cost information of their on-site asset management. Costs will not be captured at the level of individual sites, because a housing development is not a defined geographic budgetary area. Therefore the "last mile" isn't relevant to cost capture. The nature of the cost may be captured, but even then it will not distinguish between a repair on a housing estate main ("HEMs") compared to the main supplying the site at the point downstream of the bulk meter where in the counter-factual a NAV served the site.

Where the CEPA report sets out that a "disaggregated approach permits a more specific and tailored assessment of avoided activities and costs for each individual NAV site and its asset

base”, it is not a practical solution to suggest that each site has a bespoke minus calculation, particularly given the proliferation of insets awarded to NAVs. It is appropriate that there is a degree of averaging between sites in terms of the “minus” calculation, and therefore the “bottom-up” approach and “top-down” could effectively be aligned through a more granular segmentation of costs in the annual performance report providing greater transparency as to avoided costs.

One of the best potential sources of information that could assist incumbents in calibrating the calculation of avoided on-site costs is the actual costs that the NAVs incur in the place of incumbents. It would be helpful that the requirement for NAVs to publish this information in the form of the Small Company Return is reinforced by Ofwat, so that it is available to stakeholders.

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 do not agree with CEPA’s list. We note that it refers back to asset types that NAVs are typically required to operate, clean, maintain, repair and replace. Within the list there is on-site pumping which in the counter-factual that the site had been served by the incumbent we would not expect to be typical of the on-site service provision. It also refers to surface water attenuation, which again is not typical as no NAV has to date requested a surface water drainage service from us as an incumbent.

Whilst we accept that there may be occasions when these elements are found on NAV sites, we do not agree that they are typical. Therefore, we do not consider that the list as set out in the report should be incorporated in the Ofwat guidance. A revised list that would provide the common elements of avoided cost that we would expect to see for all sites is as follows:

<u>Water</u>
Water quality sampling
Regulatory compliance
Leakage detection
Mains repair and replacement
Communication pipe repair and replacement
Mains cleaning
Emergency support
Meter space

<u>Sewerage</u>
Sewer repair and replacement
Sewer cleaning
Emergency support

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

Yes, we agree with the proposed treatment of indirect costs. We currently treat indirect costs in the same way we treat direct costs, so they are allocated as a cost per meter of main in line with the proportions set out in the Regulated Accounts.

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

The approach we have adopted in calculating the annuity "minus" for capital replacement and maintenance costs is to identify the typical assets employed on the site, the mix of those assets, their associated replacement cost, and the assets lives over which to calculate the rate of replacement on the site.

We note that under new sewerage asset adoption arrangements, the developer is responsible for maintenance of the assets for one year after they are provisionally certified, and that the same is proposed for SLPs in relation to the adoption date of water assets.

Ofwat's interpretation of this, that the incumbent has (close to) no avoided capital maintenance costs for the first year of a new NAV site, may be accurate. However, given the current guidance sets out that an annuity is the appropriate mechanism to allow for the variation over time of these costs, then these new arrangements simply require a change in the period over which the annuity is calculated, rather than the removal of a minus element for this in year one of the development. This appears also to be the conclusion reached by CEPA in section 6.4 of its report.

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

We have no comment.

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

Aligned with our position in supporting the introduction and operation of new markets, since first publication, we have included within the calculation of the "minus" set out in our NAV Charging Arrangements an operating margin on ongoing operating costs drawing upon the NAV WACC calculation set out in the guidance. As detailed in section 6.4.1 of our Charging Arrangements, this approach recognises that, as a consequence of the changes in the income offset rules, where there is no upfront investment in on-site assets there can be no avoided WACC on those assets, and therefore there is no "return" available to the NAV except that included in the annuity "minus" for capital replacement.

However, absent of the position we have taken, the lack of margin for an equally efficient operator where there is no upfront investment reflects the reality of the regulatory settlement, whereby incumbent companies receive no regulatory return in relation to on-site capital costs that are now fully funded by developers and therefore have no effect on the RCV (the *quid pro quo* being higher upstream net capital expenditure as a result of the infrastructure charge discount given in place of the income offset).

Therefore, where Ofwat sets out in this consultation that an additional allowance in principle should reflect the operational risk experienced by NAVs to operate on-site assets which the incumbent has avoided, this will require incumbents to provide a return to the NAVs which they themselves are not explicitly allowed in their own regulatory settlement, thereby "eating into" the overall return that the incumbent is allowed on its RCV. Nevertheless, as a supporter of new markets we acknowledge that this is an appropriate approach.

CEPA points out that quantifying and allowing for the value of the operational risk avoided by the incumbent is not straightforward. Of the four options it puts forward, we are in favour of a return in the form of an operating margin, although one based on a margin on operating costs,

rather than a mark-up on turnover. We consider this to be the most straight-forward and transparent approach. The margin could be based on the NAV rate of return set out in the guidance. In doing so, it would provide Ofwat with an opportunity to review the methodology for calculating the NAV WACC and publish an updated calculation for AMP7.

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

The consultation sets out that the structure chosen by incumbents for their bulk supply charges may create perverse incentives on NAVs to increase water consumption. This might be the case where the "minus" element of the charge is included within the volumetric rate, so that for each additional m3 of water billed to its end customers, the NAV can earn an "arbitraged" return from the minus element through the differentiated price.

However, where, as is the case with the Anglian Water NAV Charging Arrangements, the "minus" is calculated on and deducted per property from the wholesale fixed charge that would otherwise apply (reflecting the reality of how the ongoing on-site costs are incurred), the "minus" is fixed no matter how much water is consumed. Indeed, this approach encourages the NAV to promote water efficiency, as the same reduced fixed charge (a net negative charge) will apply to a lower value of volumetric charges, increasing the margin available to the NAV.

However, it does not then follow that the guidance should state that bulk charges should not financially penalise NAVs for promoting greater water efficiency. This implies that NAVs should be no worse off whatever volumes of water their end customers use compared to the counter-factual. If the policy proposal is to be reflected in the guidance, it should rather be explicit that the structure of charges by incumbents for NAVs should not disincentivise NAVs from promoting greater water efficiency.

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?

No, we do not agree.

In principle, it is right that the charges for NAVs should reflect the long run costs incurred to serve them. It is also true that the basis under the current methodology for calculating the wholesale charges they pay is the allowed revenue set out in the incumbent's FD, itself based on the regionally averaged long-term costs of the incumbent.

Savings delivered over the long term from sustained lower PCC will be reflected in the long run costs incurred by the wholesaler, and so the allowed revenue to the incumbent. That is the point at which lower costs resulting from lower PCC should be reflected in charges.

Otherwise, reflecting the principle of discounted charges outlined above implies that the NAV receives a discounted price where its PCC differs from the average implied in the starting point for allowed revenue for the incumbent. Given this is a regionally averaged PCC for the incumbent, how far different would the NAV PCC need to be from the incumbents regionally averaged starting point in order to rationalise a discounted price? And how would the long run savings to the incumbent from a lower PCC on the NAV site be scaled?

Also, in the inverse, if the PCC is higher on the NAV site than the regionally averaged incumbent PCC, can the incumbent increase the weighted average wholesale charges to the NAV?

Q11: Do you have other comments you wish to make regarding the methodological issues set out in CEPA's report?

No, we have no further comments to make regarding the issues set out, other than to note that the report stands as a helpful contribution to the ongoing discussion.

Q12: What are your views on how changes to bulk charges for NAVs might best be implemented?

We consider that updated guidance is the most appropriate next step, in advance of which input from an industry group would be sensible in relation to advising on and testing the practicalities of any given proposal. Anglian Water is available to participate in such an industry group.

We agree that developing charging rules at this stage does not appear a priority.