



The voice for water consumers
Y corff sy'n rhoi llais i ddefnyddwyr dŵr

**CCW's response to Water Services
Regulation Authority (Ofwat)
Consultation on bulk charges for New
Appointments and Variations (NAV's)**

7th September 2020

Introduction

1. CCW is the statutory consumer organisation representing water and sewerage consumers in England and Wales. We welcome the opportunity to comment on this consultation .
2. Like Ofwat, we believe that well-functioning markets can deliver better outcomes for both current and future customers through lower prices; better quality services; and/or improved choice. They can bring new approaches and encourage innovation, which helps the industry respond to and meet its strategic challenges - such as a growing population, changing climate, affordability and changing customer expectations - in an efficient way.

Executive Summary

3. New Appointments and Variations (NAVs) are an established mechanism through which better outcomes for customers can be realised. Most NAV sites and NAV Appointees (Appointees) rely on the bulk supply of water and/or sewerage services from the incumbent company/ies. The cost of these bulk supplies and the margins available to Appointees is crucial to the success of the NAV system. The correct setting of bulk supply charges and their regulation is therefore of primary importance in the development and functioning of this market opportunity.
4. It is also vital that in the setting of bulk supply charges the customers of incumbent companies are not disadvantaged and are not required to directly, or indirectly, subsidise Appointees or the NAV market. Any system for the setting of bulk charges therefore must have adequate protections to avoid this, or other market distortions arising.
5. We welcome Ofwat's consultation and its proposal to address some inconsistencies in how incumbents have followed its 2018 guidance in agreeing bulk charges with NAV appointees.
6. The proposals set out by Ofwat will help make bulk charges more cost reflective. While not under consideration in this consultation, we would like to see customers also benefit from any reduction in bulk charges that NAV Appointees might enjoy in future as a result of any revised charging guidance.
7. Overall, we agree with the proposals set out in the consultation and that further consideration is required before any charging rules are prescribed. We give our responses to the questions asked in the consultation below.

Response to Consultation Questions

8. Q1 – Approach to Weighted Average Tariffs

We agree that a menu-based approach that reflects the actual mix of properties on a NAV site provides a more accurate and transparent way of defining the relevant starting wholesale tariff when calculating the bulk supply charge under Ofwat's 2018 guidance, than the alternative of using *ex ante* 'overall weighted average' which is not site specific. Given that the menu-based approach has become standard practice, we support Ofwat's proposal that this should be the required method for defining the relevant wholesale tariff.

9. **Q2 – Large User Tariffs**

The offer of large user tariffs by incumbents to Appointees at certain NAV sites, rather than using the wholesale minus calculation of a bulk charge, suggests that charges may not be so cost reflective at the particular site. We consider it is more appropriate that bulk charges are calculated through a consistent methodology applied to all sites. We therefore agree with Ofwat's proposal that large user tariffs should not be offered at new sites in future. This will give certainty to Appointees when considering making an application to supply a new site, as well as allowing simpler regulatory scrutiny if that is required.

We consider it would be unfair to impose this proposed guidance retrospectively to existing sites where large user tariffs are used as the agreed basis of bulk charging. Accepting that charges to these sites may not be so cost reflective, and less accurate than a wholesale minus calculation, the method of charging will have formed an integral part in the Appointee's consideration of taking on the site. Revisiting the methodology of charging after the grant of a variation could potentially affect the Appointees margins and possibly the viability of the NAV site. We therefore suggest that Appointees should have the option to agree to revisit their bulk charges agreement with the relevant incumbent but that this should not be compulsory.

10. **Q3 – Estimation of Costs**

CCW considers that the estimated costs used in the calculation of bulk charges should be as accurate as possible. This will ensure that, so far as is possible, there is no cross subsidy between incumbents and Appointees which could distort the market and potentially disadvantage consumers. We recognise the trade-off between consistency, transparency and accuracy of the methods for estimating costs. It is also sensible to consider the cost to the incumbent of the methodology proposed.

Overall, we agree that companies should use a bottom-up method of estimating costs. This will provide the most cost-reflective estimate, taking into account Ofwat's view that such a method would not be administratively burdensome to incumbents.

11. **Q4 – Common Avoidable Costs**

CCW is not a service provider, and is therefore unable to take a definitive view on the list of costs avoided given by CERA, however, it appears reasonable.

12. **Q5 - Treatment of Indirect Costs**

CCW would prefer to see all avoided costs taken into account by incumbents when calculating a bulk charge. This should include, where practical, indirect costs as well as direct costs. CERA has identified that there is currently inconsistency in the inclusion of indirect costs in incumbents' calculations. Where indirect costs avoided are not taken into consideration the bulk charge will be higher than it could be. This has the potential to distort the market by acting as a disincentive to potential NAV applications in an incumbent's area. We agree with Ofwat's proposal on the treatment of indirect costs, and that this should be consistent across the industry.

13. **Q6 – Capital maintenance expenditure**

In its report, CERA has identified capital maintenance expenditure as a further area of inconsistency in how incumbents currently estimate costs in their calculation of bulk charges. CCW supports Ofwat in addressing areas where inconsistency exists in the NAV market. We agree that companies should use a bottom-up methodology in calculating their avoided

capital maintenance and replacement costs including the use of an average annuity. We also agree with Ofwat's view that incumbents have close to no avoided capital maintenance costs for the first year of a new NAV site, where the infrastructure has been laid by a third party.

14. **Q7 – Income Offset for Welsh incumbents**

Given that the changes to the income offset for English companies – in relation to up-front costs recovered from developers - applied from 1 April 2020 do not apply to Welsh incumbents, we agree with the proposed approach that the rate of return on on-site assets will remain relevant in Wales and support Ofwat's approach.

15. **Q8 – Rate of Return for English incumbents**

No comments

16. **Q9 - Should guidance explicitly state that bulk charges should not financially penalise NAVs for promoting greater water efficiency?**

Greater water efficiency benefits consumers and the wider environment. It is therefore important that NAV appointees are not penalised for promoting efficiency through the way bulk charges are calculated. We therefore support guidance that explicitly states this.

17. **Q10 - Should NAVs 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 agree that Appointees should not be penalised for achieving greater water efficiency, including lowering per capita consumption. If discounted charges can be realised through the mechanism of avoided costs or environmental impact mitigation for incumbents, which they can pass on to Appointees, we support the proposal. We would not support the provision of discounts where this would be at the expense of an incumbent's customers and so represent a subsidy from them to the Appointee.

18. **Q11 – Additional comments**

None

19. **Q12 - Views on how changes to bulk charges for NAVs might best be implemented**

Ofwat's consultation and CERA's report highlight inconsistencies in the way incumbent companies currently calculate and publish their bulk charges while following the 2018 guidance. They do not identify any fundamental issue which impact the effectiveness of the NAV market and that require immediate action. However, the market could be improved by addressing the inconsistencies and through adoption of methodology improvements CERA has identified.

We support Ofwat's proposals set out in the consultation for updating their 2018 guidance, and its view that further consideration is required before setting out any formal charging rules, if at all.

We agree that an industry lead consideration of CERA's report, and how this can be translated into guidance, is the most appropriate and sensible way forward, but this should allow for input by wider stakeholders as well as incumbents and the regulator.

Enquiries

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