7 September 2020

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

By email: NAVpolicy@ofwat.gov.uk

Dear Sirs

Response to consultation – Consultation on bulk charges for NAVs

I am writing on behalf of Icosa Water Services Limited (Icosa) in response the above consultation that was published in July 2020. We welcome the opportunity to contribute to the consultation.

Our responses to the specific questions raised in the consultation document are set out in Appendix 1.

Yours faithfully,

[redacted]

Raoul de Lange

Icosa Water Group

APPENDIX 1

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

We do not agree with the menu or the weighted average approach. Icosa have worked in partnership with several incumbents to develop and implement an alternative approach which overcomes the inherent problems of the menu and weighted average methodologies.

We believe that the menu and weighted average tariffs have only been developed based on a perceived need to bill NAV sites using a bulk boundary meter. Put another way, the menu and weighted average methods are only necessary because of a false assumption that household and non-household demand will be aggregated and charged using a bulk meter.

In practice there are no bulk meters on wastewater only NAV sites, so an alternative charging process is necessary. Icosa has worked with several incumbents to develop and successfully implement a low-cost bulk charging process using aggregated end customer reads. With aggregation it is possible to separately aggregate the household and non-household demand. This aggregation negates the need to calculate and manage thousands of bespoke site-specific NAV tariffs. Instead, the incumbent just needs to develop a cost reflective NAV tariff for a small number of wholesale large use price bands. The incumbent may wish to keep a bulk meter as an audit check although like the electricity sector we believe that these are costly and unnecessary for charging purposes.

We have outlined some of the key concerns with the menu or weighted average tariffs below. We refer to menu and weighted average tariffs collectively as 'site specific tariffs'

1. Most new housing development sites are below 500 domestic plots and have little or no non-household properties on them. Having site specific tariffs adds significant complexity and administrative costs for NAVs and incumbents and generally produces a negligible adjustment to the overall boundary charge.

2. Site specific tariffs are already becoming increasingly unmanageable for NAVs and Incumbents to administer as competition in the industry grows. The concept of having thousands of bespoke site-specific tariffs is unrealistic. It will not only necessitate substantial IT investment throughout the water industry, but it will also impose significant ongoing costs in producing and processing thousands of monthly site-specific invoices. Based on our work with several incumbents there is a mutual desire to keep the charging interface as simple and low cost as possible so we would favour an approach using aggregation of end customer meter data. This would mean having a handful of equivalent large user NAV tariffs rather than tens of thousands of bespoke site-specific tariffs. The customer meter aggregation will be necessary in any event on wastewater only NAV sites where there is no bulk meter.

3. There is evidence that weighted average tariffs are not always cost reflective. Weighted average NAV tariffs can be more expensive than the large user wholesale charges on larger developments when certain volumetric thresholds are achieved. Some incumbents have already acknowledged this anomaly and have accepted that NAVs should be free to switch to the wholesale large user charges if these are cheaper than the NAV tariff.

4. Non-household demands are highly unpredictable with changes in building use, seating density, partial occupancy, voids, and shorter building life expectancies. The economic upside (if any) of having site specific tariffs is so uncertain that it adds no value other than the potential for a small upside in the future when any non-household load materialises.

Q2 Do you agree that large user tariffs should not be offered for new NAV sites?

We do not agree for the following reasons:

1. This would inevitably result in NAVs making negative margins on large non-household customers (or large aggregated non-household loads). In our experience, it is not uncommon for the large user tariffs to be cheaper than the currently available weighted average NAV tariffs on large developments. Consequently, NAVs would end up paying more to purchase the services from the incumbent than they could make selling the same services on to the non-household suppliers. Ultimately, there is a risk that NAVs would be unable to compete for large new developments. These large developments (1000+ plots) are the NAV markets most prized market and one which should have better NAV markets as (CEPA agreed) 'last mile' networks on waste and potable water displace more of the incumbents assets and cost and therefore this should be evidenced in the tariffs available.

2. Per our response to Q1, we believe that the difference in NAV and bulk wholesale charges is fundamentally being caused by a perceived need for NAV charges to be based on a bulk supply meter. The same anomaly was identified and resolved in the electricity industry by moving to aggregated end customer reads rather than using bulk meters. Icosa has already proven that this system works cheaply and effectively with a number of incumbents and, as with electricity, the incumbents may wish to retain bulk meters until such time that they are satisfied that NAV losses are in line (or below) the embedded assumptions they have made with their NAV tariffs.

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

Both approaches sound reasonable, but it might be pre-emptive to choose one without understanding the potential range in outcomes that they have across different water companies.

Several important lessons were learnt when the electricity industry developed its common distribution charging methodology "CDCM" pre 2010. One of the key lessons was speed at which the various methodology options could be evaluated when a single independent economic consultant (Reckon LLP) was appointed by the DNOs to centralise the task of assimilating the data, testing and agreeing an optimum methodology and then applying it in a consistent way.

Another key lesson from CDCM was that even with a very credible common charging methodology it was still necessary to apply top down scaling of the calculated tariffs in order to make the tariffs financially consistent with the high level price controls/ allowable revenues of the incumbents. It is also important to mention that significantly different levels of scaling were necessary for different incumbents despite a common methodology had been used.

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?

The list provided by CEPA looks reasonable in terms of the direct costs and we believe it would help to include them in the guidance.

Of interest to Icosa is the recognition of wastewater storage and pumping station costs within the avoided costs, which is often ignored as an avoided cost by incumbents. Wastewater margins in some incumbent are particularly poor as reported by CEPA.

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

We agree. Indirect costs are generally regarded as being the first component of an avoided cost methodology so NAV tariffs should include a provision for indirect costs.

It is not clear from the CEPA review if any work has been undertaken on the avoided retail costs. We have a general concern that there seems to be quite a varied level of retail margins between different companies and we are conscious too that the retail costs of certain incumbents can be different depending on whether they are providing the full water and wastewater service or just one of these services.

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

We broadly agree with the proposed approach to capital maintenance and replacement expenditure i.e. using an average annuity to fund the lifecycle repair and replacement costs.

We do not think the Incumbents should be allowed to cherry pick lower avoided costs of new network when customer charges are based on recovering the average maintenance and replacement cost across the whole portfolio. In our experience new networks can also experience teething issues even after the first year as problems manifest, particularly while site construction is still underway and new loads are being added which stress the performance of existing adopted networks.

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

It is arguably irrelevant. Welsh Water and the Welsh Assembly have effectively foreclosed competition from NAVs in Wales (knowingly or otherwise) by implementing different legislation for the adoption of sewers. Bringing Wales in line with English operating practices would open the area to competition in which case we would support the proposal to include a rate of return element.

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

We agree that the incumbent does avoid operational risk on new assets and so should make an allowance for this in the NAV charges. We do however have other broader concerns relating to the way the avoided cost methodology seems to give the incumbent a competitive advantage on new network because of the introduction of new developer charging arrangements.

In our view, the incumbent is charging new customers the same as existing customers irrespective of the fact that new network is now being funded by the developer. If incumbents no longer have the cost of funding new network to avoid, they actively choosing to still recovering the income from new connections to pay for it and simultaneously denying NAVs the right to receive an equivalent income. In our view we believe this is giving the incumbents a competitive advantage on new connections.

Whilst income offsets and new connection charging methodologies have seemingly levelled the playing field, the reality is that (a) NAVs are still having to fund an element of capex in order to compete with the incumbents and (b) NAVs are funding capex because they are struggling to receive any income offset payments from the incumbent.

In our experience, developers want more than just a marginally cheaper connection cost to incentivise them to use a NAV. This could be because they have experienced problems in the past where incumbents have imposed delays on the NAV boundary connections or because there is an additional time delay associated with the NAV licensing process. Either way, we believe that some element of capital contribution is necessary from the NAV towards the initial cost of the network to compete against the incumbent. We believe that the avoided cost methodology is denying NAVs an equivalent income to the incumbent and thus making it harder to find savings with which to make a sufficient capital contribution to compete.

In many cases, the new arrangements for income offset have yet to be developed but it is worth highlighting that Icosa has struggled to receive any income offset under the interim arrangements. In chasing numerous overdue income offsets, incumbents have provided a range of excuses to delay or dispute payment including:

- Incumbents not having a budget to pay income offset,
- Incumbents being unable to pay income offsets because they are outside the scope of their existing funding facility,
- Incumbents have not having internally agreed the guidance on the information that NAVs should provide to support an income offset claim
- Incumbents have denied payment even with a completed claim on the basis that they have not yet provided Icosa with a letter of confirmation for the income offset amount
- Some incumbents have been willing to make stage payments whereas others expect the work to be fully funded and completed by the NAV before they will make an income offset payment.

We believe that more work is necessary on this area to ensure that the new arrangements work and the avoided cost methodology does not have an adverse impact on the fragile level of competition that currently exists in the water industry.

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

We support this in principle, but it may be hard to achieve and even unnecessary given that the customer volumetric tariffs already incentivise customers to minimise their consumption.

In practice, the costs of owning and operating last mile networks are almost all fixed and being driven by the installed network capacity rather than customer consumption. For example, the service pipes will be the same size irrespective of customer use and the costs of customer billing, meter reading, customer service, water quality management etc are all fixed irrespective of the level of customer demand.

Whilst it would be nice in principle for NAVs to receive a flat capacity charge we would argue that it is much more important that the incumbents recognise that the NAV income is already being driven by the lower household consumption of modern water efficient new homes i.e. a lower average demand than the incumbent will enjoy across its portfolio which is based on a mix of new and old homes.

In illustrative worked examples of NAV margins, we have seen incumbents using assumed average consumptions that might be 30%-40% higher than we see on our NAV networks.

On a separate but related point, we have not seen any mention that the NAV tariffs should include an allowance for social water tariffs such as Watersure. We believe this needs to be taken into consideration in the methodology and can easily be achieved if the industry moves to a new charging approach which is based on aggregated customer reads rather than bulk meters.

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?

In terms of NAV incentives for lower per capita consumption then we agree.

In terms of SUDs we disagree on the grounds that there are already bespoke and unregulated charging arrangements in place which recognise that different sites deploy a wide range of drainage solutions from cheap ‘dry ditch’ solutions to ornate feature ponds and underground geo-cellular crates. In our view it would be inappropriate to expect the general portfolio of customers to fund expensive SUDs solutions such as ornate drainage ponds or geo cellular crates.

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

As mentioned earlier, it would be good to have a similar level of scrutiny around the avoided retail costs since these appear to vary from one incumbent to the next suggesting that different assumptions have been made. We are also interested to understand the impact on avoided retail costs when the incumbent is providing water, wastewater or both services since this is common at most of the WASC boundaries.

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

As mentioned earlier, we strongly support an industry led approach as was eventually used in the electricity industry to develop CDCM. It makes the whole process easy for the incumbents and the NAVs by avoiding the need to develop (and justify) individual methodologies. It also enables all the methodology options to be quickly appraised and ensures that the agreed methodology is applied consistently.

Longer term it will also significantly reduce the time and cost of change management because it allows a user forum to be set up to review and manage change requests etc.

We strongly support Ofwat being much more focused on exact rules and definitions rather than leaving interpretation and working practices to the incumbents.