7 September 2020

Consultation on bulk charges for New Appointments and Variations

Leep Networks (Water) Ltd – response

Rachel Fletcher
CEO Ofwat

Dear Ms Fletcher

Leep Networks (Water) Ltd (formerly SSE Water Ltd) welcomes the steps being taken by Ofwat to bring about improvements in the NAV process and the general industry approach to specific elements of the market.

We have been encouraged by the broad adoption by incumbent companies of the charging guidance issued in 2018, though we agree with CEPA's findings regarding the lack of clarity and consistency relating to the various methods used by incumbents to arrive at their tariffs.

The establishment of charging rules based on the findings of CEPA and the responses to this consultation may go some way to eliminating this lack of clarity, though we would state that at present we express no particular preference for the use of rules over enhanced guidance. Your comment regarding the likely reduction in disputes should rules be introduced is valid, though we assume that disputes requiring determination are relatively uncommon and, as such, the potential inflexibility of rules may outweigh the advantages.

We agree with the principal of wholesale-minus approach to the setting of bulk NAV charges and acknowledge that the bottom-up approach is likely to be the most cost-reflective. We do, however, have some reservations about the sole application of a such a menu driven approach, predominantly owing to the potential administrative burden it may impose. We give further details below.

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

LNWL currently receives bulk tariffs based on both ex ante and menu driven approaches. The former is undoubtedly simpler and provides a known tariff on which to model a potential site. Conversely, the menu driven approach may require a NAV to provide to the incumbent a detailed appraisal of the projected construction of the site, the property mix, consumption patterns and projected mains length per unit before being able to produce a reliable financial appraisal. Notwithstanding the additional time burden this implies and the possible delay in response from the incumbent, there may be an on-going need to repeat this process throughout the life of the site, with likely reconciliation efforts during each financial year and possible rebates or further invoicing.

If a menu-based approach is to be used across the board, we believe it would best be implemented by a universal requirement to provide a 'tariff calculator' allowing a NAV to conduct its own investigations without direct contact with the incumbent and to test different scenarios for a prospective site.

We would therefore suggest that there is some merit in incumbent companies providing a choice of approach, with an optional top-down tariff provided to enable a NAV to rapidly and easily assess whether a site will be financially viable.

Q2a: Do you agree that large user tariffs should not be offered for new NAV sites?

Large User (LU) tariffs are generally seen as being commercial tariffs, designed to reflect the reduced costs of serving a site with a stable and predictable supply pattern. Such tariffs would not ordinarily apply to residential consumption, though large hotels and halls of residence (for example) may well operate within such a consumption band and receive the benefits of a large user tariff. As LU tariffs form part of the incumbent's published charges, a NAV would be expected to provide the option of an equivalent tariff to such customers within its appointed area. If the LU tariff was denied the NAV and this tariff was below a specific tariff which the NAV is paying to the incumbent, the result would be an anomaly whereby the NAV could be subsidising a section of its customer base We are aware of at least one example where this could occur.

We therefore see a potential conflict with the Large User criterion for a NAV appointment, whereby a NAV that was restricted to a tariff potentially higher than that which a prospective client would pay to the incumbent would be unable to compete on a level playing field, if such tariffs were not available to the NAV.

In most cases, the Large User tariff is higher than the applicable NAV rate hence we do not agree that the availability of Large User tariffs encourages inefficient entry to the NAV market. Large User tariffs are not normally applied from the beginning of a site and would only come into force through the ongoing development of that site. A NAV will make its site assessment based on a number of factors; if the LU tariff was a significant input, it would be reasonable to assume that NAVs would strongly favour sites which would quickly reach a large user threshold. The existence of many smaller sites, which are unlikely to attain the required consumption to broach an LU band, suggests that ultimate consumption is not the only driver.

To help avoid anomalous outcomes and to ensure a level playing field, we would suggest that these tariffs should remain as an option until such time as further examination could demonstrate their ongoing applicability and cost-reflectiveness, or otherwise, to the wider customer base of the incumbent companies.

Q2b: What should the approach be to existing sites?

Pending the outcome of any further examination of Large User tariffs, we would support the option for contracted parties to retain such tariffs, with agreement, where they are currently being applied. We also support the option of contracting parties to retain tariffs negotiated outside the current guidance that do not necessarily align with either Large User or 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?

We generally agree that a menu-driven bottom-up approach is likely to provide the most accurate tariff based on avoided costs, but would note that there is a balance to be struck between accuracy and simplicity; this is most likely to be of importance for smaller, predominantly residential sites where the additional accuracy of the bottom-up method may be of relatively little consequence. It may therefore be of use for incumbent companies to provide a 'standard' tariff based on the top-down method alongside the ability for NAVs to design a site-specific tariff via a calculator.

Q4a: Do you agree with CEPA's list of common avoided costs or should additional items be included?

We agree with the list provided by CEPA as it contains most elements that should be included in avoided costs. We do, however, support the inclusion of on-site leakage and other non-billable consumption as under the bulk supply contracts NAVs are required to pay in full for the flow through the boundary meter(s), allowing the incumbent to avoid the costs associated with such consumption. Further, we would also suggest that the wholesale element of on-site customer debt should be considered, as this is also avoided by the incumbent. We are aware also that other respondents may make reference to the treatment of vacant properties on a NAV site and would support guidance on how this may be considered.

Q4b: Should we incorporate this list in our guidance?

We agree that a list should be included in the guidance, though it should not be limiting.

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

We agree with this approach.

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

We agree with this approach.

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

We agree with this approach.

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

We have no comment on this question.

Q9: Should our guidance explicitly state that bulk charges should not financially penalise NAVs for 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.

We agree that actions taken by NAVs (and incumbents) to reduce demand has a wider benefit to society. Such action may have an immediate cost, for example the use of technology and regular customer campaigns. The associated long-term cost / benefit of reduced consumption and the subsequent reduction in income is difficult to assess accurately but it is reasonable to assume that an overall reduction in per capita demand directly translates into reduced forward spending by the incumbent on reservoirs, treatment, pumping etc. We consider that an evidenced-based campaign by a NAV to reduce consumption could be linked to this wider benefit, reflected in a reduction in the relevant bulk tariff. We also consider, though beyond the scope of this consultation, that, in time, thought must be given to financially based demand management, through appropriate customer tariff structures.

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

We have no further comments in this respect.

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

We agree that rules are, at present, not required and that enhanced and more detailed guidance is preferable. We believe that it will be necessary to closely monitor the incumbents' application of any new guidance and that doing so may expose wider benefits in terms of creating greater clarity within the industry relating to matters of costs and how they relate to charges.