Northumbrian Water response to Consultation on bulk charges for New Appointments and Variations (NAVs) (July 2020)

Summary
Northumbrian Water is committed to ensuring a level playing field for NAVs in the new development market. We welcome the CEPA report and have found it very useful. The report classed us as B overall and we were deemed to having met the Ofwat requirements in relation to the publication of tariff information.
We note that one area of improvement is for us to develop an on line tariff calculator; we already have this at a development stage and we will be working on it further this year in order to finalise and publish this tool.

Our response is generally supportive of the Ofwat proposals, although we draw Ofwat's attention to our responses to Q3, Q8 and Q10 where we have expressed some concerns and alternative proposals.

Q1: Do you agree with our proposed approach to weighted average tariffs?
Northumbrian Water publishes wholesale tariff starting points and deductions separately for households and non households to allow a menu based approach. We agree that this is a reasonable approach to set as best practice.

Q2: Do you agree that large user tariffs should not be offered for new NAV sites? What should the approach be to existing sites?
The Northumbrian Water NAV bulk charges guidance confirms that large user tariffs are not applicable for NAV sites. We agree that NAV charges should be calculated and used separately from large user tariffs, which are calculated for a different customer group.

Existing sites should transition to NAV tariffs rather than large user tariffs unless there are prior contractual reasons why this cannot be done. We can confirm that all our NAV customers are now on our 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 have concerns that this proposal increases the regulatory burden on incumbents and is less transparent for NAVs.
We currently use a top down approach to assessing the costs avoided for operating and maintaining on site assets. Whilst we have detailed cost information on asset management, it is not split between on and off site costs, as there has never been a regulatory or practical reason for adding this level of complexity to cost recording for the operational teams that work in an integrated way across the full network. Requiring this split would add to the administrative burden for the company.

Bottom-up approaches would significantly reduce transparency for NAVs. We would be interested in the view of NAVs for these options, as our discussions with NAVs suggest that they prefer the transparency of references to published costs. For example, it is possible that a bottom up approach could identify that on-site costs are lower than assumed from the top down approach. We have seen no evidence to suggest that a change to a bottom up approach would produce either a more accurate outcome or indeed produce benefits for NAVs or Customers. Accordingly we remain unconvinced of the merits of such approach compared with the significant additional administrative burden.

As a compromise, a 'middle-down' approach could improve transparency, although splitting operating costs between on and off site would still impose an additional administrative burden on the incumbents.

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 agree, the CEPA list of common avoided costs is a useful checklist. As previously noted, to require a bottom up assessment split of all of these 'whole company' costs between on site and off site costs would increase the regulatory burden considerably.

We note that there are multiple cost drivers identified. Northumbrian Water currently uses the number of properties as the key driver of avoided cost. NAV applications typically identify number of properties as their initial single driver of costs. To require NAVs to also identify length of main or sewerage to calculate their NAV tariff would increase their burden of making an application and increase the complexity of the calculations as the site is redesigned (as frequently happens).

Q5: Do you agree with our proposed treatment of indirect costs?
We agree. As per the Regulatory Accounting Guidance, Northumbrian Water includes an allocation of indirect costs in the relevant lines of the APR that we use for top down cost allocation. We note that this allocation will be less transparent should Ofwat move to a bottom up approach.

Q6: Do you agree with our proposed approach to capital maintenance and replacement expenditure?
We agree that there should be an allowance for the capital maintenance costs avoided. We also agree this is best done on an averaged approach and an equivalent annuity would be a reasonable approach (similar to the way a depreciation charge would be funded in price limits).
We agree that, where a developer would be expected to pay for maintenance, it should be assumed that this equally applies for NAVs, so there are no capital maintenance costs for the first year.

Q7: Do you agree with our proposed approach to the income offset for Welsh incumbents?
This is not applicable for Northumbrian Water.

Q8: Do you have other comments on the rate of return with respect to English incumbents?
We agree that, as developers now fully fund the cost of on-site assets, these costs are no longer avoided by the incumbent and there is no need for an allowance for capital funding (WACC, depreciation).

NAV profitability should depend upon them being more efficient than the incumbent. To set tariffs that encourage inefficient entry would be detrimental to customers overall, who would be subsidising inefficient entry.

The current regulatory system allows for returns based on net capital invested. For new developments where the capital is matched by developer contributions, there is no net increase in RCV and hence no increase in returns. Thus, an incumbent has to absorb the additional operational risk of new developments without additional funding. To make a tariff reduction allowance for a NAV for a cost that is not avoided by an incumbent would mean incumbent customers would be paying more in order to fund this margin.

The point at which a return start to be made by the incumbent is when capital costs not funded by developer begin to be incurred – i.e. capital maintenance. Thus, to mirror the NAV allowance for avoided costs for the incumbent, the capital maintenance annuity should include the Cost of Capital on that investment (in practice, used as the discount rate for the annuity).

This is in line with Option 4 of the CEPA report (Table 6.1), and as they note, is fully consistent with the wholesale minus and incremental cost approaches.

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?

Northumbrian Water Bulk Charges to NAVs are 100% volume related for the water service. **As such, the bulk charges are automatically discounted for water efficiency and NAVs receive the full benefit of this.** In turn, NAVs can charge their household customers a combination of fixed and volume charges, so a volume reduction by their household customers could even increase the NAV margin.

To illustrate this, for a NAV to ensure that the water efficiency incentive always applies for them is to set the household volumetric rate lower than the NAV bulk supply volumetric rate. In this way, NAV costs fall faster than income as volume falls. It can then recover the rest of its costs through the fixed household charge. If this is not possible under current rules, then we encourage Ofwat to allow a NAV to do so. As Northumbrian Bulk Supply charges offer the maximum efficiency incentive rate possible, the only decision left for the NAV is to decide how this incentive should be split between themselves and the households. It should be possible for both to be incentivised.

For wastewater services, on-site drainage systems are strongly incentivised by the fact that, if no surface water is sent to the incumbent, then no bulk supply surface water charges will be made to the NAV (i.e. a 100% incentive rate).

In addition to this, we offer lower infrastructure charges for sites that are water efficient or do not require surface water drainage. This is offered to all developers, including NAVs and should help in incentivising the initial capital outlay for water efficiency / on site drainage.

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

The CEPA report is very helpful in setting out the approaches taken and identifying best practice where applicable. It is also careful to set out the pros and cons of difficult areas, which we have referred to in our response.

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

We agree that incumbents should be given time to review and respond to the useful CEPA report. We would support an industry led approach to delivering improvements and agree that this will need to be carefully facilitated to manage any competition issues. The approach should focus on the establishment of and sharing of best practice, harmonisation of nomenclature and the simplification of approaches and processes; but with an emphasis on the avoidance of any areas with competition concerns. It is our view that any rationalisation or simplification where competition risks arise would best be achieved by the application of regulatory guidance or instruction

Northumbrian Water
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