Consultation on bulk charges for new appointments and variations (NAVs)

Severn Trent response

September 2020

WONDERFUL ON TAP

Summary of response

We think CEPA's report is a helpful review of NAV charges and we would welcome the opportunity to study some of the detail behind it; while we can infer which of the anonymised companies is Severn Trent, it would be helpful if we could confirm this. We first brought forward a wholesale-minus NAV tariff in 2016, but this remains a relatively novel approach so we have updated our approach to take account of new guidance and best practice from other companies as it has developed.

Existing NAV sites in the Severn Trent region have all been moved onto a wholesale-minus tariff. For those that started before the change in the income offset rules, we continue to apply a higher discount reflecting the financing costs of infrastructure on site. While we do offer NAVs the option of a large user tariff, we would be content to withdraw this provided Ofwat does not consider this to represent undue discrimination. We discuss some of the reasons why large user tariffs differ from the wholesale-minus NAV charge in our detailed response.

We support Ofwat's proposals on weighted average tariffs and the use of a bottom-up cost assessment for NAV sites. Regional averages will inevitably over or under-represent the costs on a particular site. The impact of both outcomes needs to be considered, since NAVs compete within a wider market for new developments alongside Self-Lay Providers. In general, we consider that the position on costs is reasonable and the itemised list in the CEPA report is a fair representation of the NAV activities that need to be funded through the wholesale discount.

The consultation highlights the problems that could arise from being overly-prescriptive – the 2018 guidance envisaged that depreciation and a return on capital would form part of the discount, but following changes to the "income offset", NAVs will now have little or no initial investment to allow for under such an approach. We believe that we have an alternative which works for an asset-light business, so we welcome Ofwat's suggestion that its guidance will be more flexible in this area.

In a similar vein, we think that explicit guidance on water efficiency – while well-intentioned – could be difficult for companies to implement. We think the issue lies not so much with the bulk supply charge and more with the form of the NAV's control, which is not a revenue cap like incumbents. We would favour incentives for NAVs to pursue water efficiency over tariff changes.

We agree that Ofwat should not consider charging rules at this point. Bespoke NAV charges are still quite new and there are advantages to having some flexibility as they evolve. We are happy to work with the rest of the industry to develop best practice, but we think that it will be important for Ofwat to be involved at all stages. We are concerned about the way that an industry-led process might be perceived by NAVs and think that companies would be hesitant to agree an approach to pricing.

Kind regards

Shane Anderson
Director of Strategy and Regulation

Response to detailed questions

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

We agree that a menu-based approach reflecting the actual mix of properties on site will be more accurate and transparent. Our published NAV model calculates charges based on the characteristics of the NAV site, including the types of property. Most NAV sites are wholly residential (all NAVs in the Severn Trent area are housing developments) and therefore the indicative rates that we publish for a typical site should be reasonably representative. However, as the market develops we expect to see more varied sites and it is important that we are able to cater for this eventuality.

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

Offering large user tariffs

Severn Trent is one of the companies which still offers large user tariffs as an option for new NAV sites. We do this because there is a possibility that the bottom-up calculation of site costs that we need to allow for could lead to a lower discount than the large user tariff for the volume of water being supplied. To date this has never happened, but it is possible.

Before we introduced our wholesale-minus tariff, large user tariffs were the only option available to NAVs. The industry had taken the view that this represented equality of treatment with other customers and avoided undue preference (consistent with Condition E). From the NAV perspective, the most obvious problem with this approach was that it made smaller sites unviable and closed off most of the market.

When we brought in our NAV tariff, we took the view that we could consider NAVs as a different class of customer because they were delivering part of the infrastructure, and therefore giving them a discount did not represent "undue" preference. This discriminated in their favour, recognising that they were bearing costs that other customers did not. But if we were to say that they could not apply for a large user tariff that is offered to other customers, this could be viewed as discriminating against them.

Ofwat is right to consider that the relationship between wholesale minus NAV tariffs and large user tariffs (LUTs) is a potential problem. This does not mean that large-user discounts are not cost reflective, only that they do not reflect the costs that a NAV will have to bear.

LUTs have been in existence for many years, most having been established when Ofwat approved charges directly. The basis for the discounts is recognised in charging rules that Ofwat has issued since the start of AMP6 – large users generally connect to larger mains and hence use less of the local distribution network. This is very much a top-down method, based on average network costs; it includes types of local distribution assets that may not be present on a NAV site (for example, pumps and storage). As noted in response to Q3, we agree that a bottom-up approach is much more appropriate to NAVs; the use of a generic LUT could either impose a margin squeeze where costs are high, or encourage inefficient entry where they are low.

In summary, we would support a restriction on Large User Tariffs being applied to new NAV sites, provided Ofwat is satisfied that this does not represent discrimination against NAV operators.

Treatment of existing sites

All of our existing NAVs were moved to the wholesale-minus approach because this gave a higher discount than regular tariffs (even for those large enough to qualify for intermediate or large-user discounts). Before the change in the "income offset" rules, NAVs were required to finance their own infrastructure, so we allowed a significant margin to finance the mains laid on site.

Under the new rules, there is an expectation that developers should pay for local assets and that the "income offset" should be available to NAVs. This presents an issue for NAVs which started operating before AMP7 – they cannot retrospectively ask the developer to fund the mains on site. Our approach has been to "grandfather" the level of discount on pre-AMP7 sites so that the "income offset" continues to be reflected through the bulk supply discount.

There are, however, some transitional issues because some sites begun in AMP6 could expand after the start of AMP7. In our view, the simplest approach is that additional properties connected on those sites after the start of AMP7 should not qualify for an income offset because this is already reflected in a higher bulk supply discount. The alternative would be to pay an income offset on connections made after 1st April 2020 and calculate a weighted average discount for the site.

NAVs appointed under the large user and unserved criteria

When we first introduced our NAV tariff, we restricted this to the "unserved" criterion because it did not appear to be relevant to those circumstances.

With a large user NAV, the operator will not create new infrastructure, so there is no additional cost that needs to be deducted. We are content to offer a wholesale minus tariff but the end result will probably be the same:

- If we were to serve the site directly, we would charge the customer on a large user tariff, so this will be the relevant starting point for a wholesale-minus approach;
- There would be no deduction for maintenance as we would not maintain the pipes on site (these are supply pipes which belong to the customer);
- The meter will remain at the boundary with Severn Trent's network (the NAV would not double-meter the customer);
- The NAV operator's retail costs are already excluded from the wholesale tariff.

We are also happy to offer a wholesale minus for variation by consent – we think this is more likely to arise between two incumbents - for example, we varied our border with South Staffs because it was much easier for them to lay a main to a new development than for us. However, it is possible for an arrangement such as this to be made with a new appointee.

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

In our view, a bottom-up approach is more appropriate. An average based on our network costs is likely to include types of assets that will not be used on a NAV site, and will inevitably over or under-reflect the cost that we would incur if we were to serve the site directly. An obvious example is pumping: most NAV sites will not require any on-site pumping, but if they do then that will be a significant cost. If we were to include an average pumping cost per metre (or connection) based on our network, that would not be sufficient to cover site costs; conversely for NAVs that have no pumps we would be making an allowance for a cost that does not exist.

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?

This is a fair summary of the on-site costs, and it would be reasonable to include it within guidance.

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

We think it is reasonable to take account of indirect costs when considering the appropriate level of margin that should be allowed. When assessing costs on a bottom-up basis, we take account of general overheads by applying a mark-up to costs. There are also some items that are normally considered as overheads that we have included as a line item – for example, regulatory fees to Ofwat and CCW – because they are based on turnover and therefore relatively significant for a NAV.

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

We agree with the guidance. Costs can be expected to rise over time; it is sensible to calculate an annuity which takes account of both the value and the timing of maintenance costs.

Q7: Do you agree with our proposed approach to the income offset for Welsh incumbents?
Q8: Do you have other comments on the rate of return with respect to English incumbents?

In our response to the 2018 guidance, we highlighted the issues with a "building block" approach to NAV margins (given the changes to income offset rules which were then being contemplated). NAVs which have begun after the start of AMP7 are asset-light businesses, with the initial cost of construction being borne by developers. If building block approach is used, there is no asset base to which a return on capital can be applied and no depreciation.

In our NAV tariff (which pre-dated the Ofwat guidance), we applied a discounted cashflow approach. This implicitly allows for a return on capital and remains valid for an asset-light business. While the "building block" approach that was laid out in Ofwat's original guidance could still work in Wales, we think that it would be sensible to be less prescriptive in this area. Several alternatives are put forward in CEPA's report but we continue to favour the DCF method which we originally applied, as this will work whether the assets are owned by the NAV operator or not.

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?

Bulk supply charges for NAVs need to be based on volume because this is important in providing incentives for the efficient use of water – particularly the management of on-site leakage. But Ofwat is right to recognise that there is little incentive for NAVs to manage the consumption of customers on site because they operate under a relative price control. Their prices are pegged to ours, and since new build sites are fully metered they will earn more revenue (and profit) if they sell more water.

Our charges to NAVs do not offer increasing discounts at higher volumes – a uniform volumetric rate is applied with a discount based on the costs of the site (there is no “falling block” or similar). The discount would only increase if there were higher costs associated with a large site (for example, because the site incorporated a larger proportion of the value chain). The issue is not so much with the bulk supply charge as with the charges to the NAV’s customers. This is not something that we can fix through our charges to NAVs. When we serve sites directly, we have every incentive to promote water efficiency because we operate under a revenue cap. But for Ofwat to create this type of system for NAVs would be disproportionate and it is not something that incumbents could synthesise through bulk charges.

Even with a flat-rate bulk supply charge, it would be very difficult for incumbents to demonstrate that NAVs wishing to promote water efficiency would not be worse off. The most that could be done is an increasing block tariff (IBT) – charging less at low volumes and more at higher volumes. But for this to be remotely fair we would need to take account of the number of people on site, the nature of business customers and so on - this would be both intrusive and complex.

It might be more practical for us to offer incentives to promote water efficiency rather than altering the structure of bulk charges to achieve this objective. As Ofwat note, there are already discounts available for developers that build water efficient homes and these are available to NAVs (our discount scheme is offered for a standard of 110 litres pppd). We could also consider ways to encourage NAVs to promote water efficiency on a continuing basis. This could include a discount or rebate for demonstrating a sustained reduction in consumption on site; we would provide the same free or discounted water efficient appliances that we make available to our own customers, making this cost-neutral for the NAV.

There are already strong incentives for NAVs to implement sustainable urban drainage systems (SUDS). We offer an environmental discount on all new developments if there is a connection to our network via SUDS, with a higher discount if there is no connection at all. There is also a continuing benefit for NAVs if their site has no connection because they will claim the whole of the drainage charge that they collect from customers. Where there is a connection, we will generally base bulk discharge volumes on customer meter readings. However, the NAVs have the option of metering discharges from the site directly if there has been significant attenuation of surface flows through SUDS, and this will reduce the charges they pay us.

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

We would welcome the opportunity to view some of the detail behind CEPA’s assessment. While we can infer which of the companies represents Severn Trent, it would be helpful to be able to confirm this (the assessment of other companies could remain anonymised).

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

In our view, there would need to be significant Ofwat involvement in any industry group that might be set up to review charges. Without this, companies will be hesitant to discuss matters relating to pricing. While incumbents are not in competition with each other, there could be concerns about the way that NAVs might perceive the industry coming together to agree an approach to pricing.

It would certainly make sense to update the 2018 guidance, at least to take account of the change in asset ownership which makes the “building blocks” to depreciation and returns more problematic. Some of CEPA’s findings could also be incorporated.

We do not think that charging rules should be introduced at this stage. As illustrated in our response to Questions 9 and 10, a well-meaning piece of guidance to promote NAV water efficiency could be difficult to implement in practice. If this type of wording was put into a charging rule, it would be very hard for companies to demonstrate that they were compliant.