

Ofwat consultation on bulk charges for New Appointments and Variations (NAVs)

South East Water response

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1. Introduction

This paper sets out South East Water's (SEW) response to Ofwats consultation on bulk charges for new appointments and variations (NAVs)

Any queries in relation to this document should be sent to

[REDACTED]

2. Answers to consultation questions

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

We agree that a menu based approach provides a more accurate and transparent solution, than the overall weighted average tariff approach, when determining an appropriate starting point for the bulk supply price calculation. It allows the NAV flexibility in choosing its service delivery package, for example the inclusion or not of water efficiency activity, leak detection services or emergency repairs etc.

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

We agree that large user tariff should not be offered as relevant starting point for the calculation of the bulk supply price for NAV sites.

NAV sites granted under the unserved criteria are primarily composed of household properties, with small numbers of commercial units. Large user tariffs do not reflect the avoided cost profiles of these sites.

SEW don't have any existing NAV sites on large user tariffs, so we don't have a preference regarding Ofwat's approach to these going forward.

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

The bottom up approach relies on assumptions to generate the cost estimates. While this is arguably more cost reflective than other approaches, there is a loss of transparency and an increase in the complexity. There will be differences in the methodology used by incumbents to estimate each avoided cost element. This will make it harder for NAV's to understand and compare the bulk supply prices offered by different incumbents.

Using a more granular accounting segmentation approach (middle down) which is based on actual performance figures, provides a transparent solution which is simple to administer and audit.

Our view is that middle down approach is the optimal solution as it achieves the right balance.

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 with CEPA's list of common avoided costs and have no additional cost items to add. It is reasonable to incorporate this list into Ofwat's guidance.

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

We agree that common costs (indirect costs) that the incumbent avoids due to the NAV operating a site in their area, should be taken into account in calculating a bulk supply price.

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

Capital maintenance and replacement expenditure are avoided costs and should therefore be included in the avoided cost calculation. As these costs vary significantly over time, the use of an average annuity would be the best way to estimate these avoided costs.

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

NA

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

We agree that it is reasonable for a rate of return to be included in the bulk supply price calculation. CEPA's report proposed four different approaches to calculate this element. Our preference is for the avoided cost methodology, as this is consistent with overall wholesale minus approach used to calculate the other elements of the bulk supply price.

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

We agree that management of demand and protecting the environment should be important parts of the charging framework for NAVs. The bulk supply charges need to provide the correct incentives to NAV's in this regard. We are however unsure as to how this can be delivered effectively.

We accept that the cost base for a NAV does not change significantly with a change in demand. Therefore the £/m³ approach to bulk supply charging does potentially incentivise increased use or de-incentivise decreased use for NAVs.

The avoided cost approach already provides funding to the NAV for water efficiency at the same £/m³ level as the incumbent. The NAV will only be “penalised” for additional water efficiency expenditure if they aim to achieve a greater level of water efficiency than the incumbent. The question is how can you reward the NAV if they choose to achieve a lower PCC for a specific site?

The impact of increased water efficiency or sustained lower per capita consumption at an individual NAV site (e.g. 200 to 400 properties), is unlikely to delay capital investment expenditure related to the incumbents supply and demand balance. The avoided cost principle in the bulk supply price calculation may not work here as the NAV is now incurring costs that don't necessarily generate avoided costs for the incumbent.

In principle Ofwats proposal to change the guidance to explicitly state that bulk charges should not financially penalise NAVs for promoting greater water efficiency, is sound. However the mechanism to reward NAV's for these behaviours needs to be developed and defined before the change to the guidance is made.

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?

Our response to Q9 covers Q10 as well.

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

No comment.

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

The use of guidance documents by Ofwat in regards bulk supply pricing, as opposed to introducing charging rules has allowed incumbents and NAVs the flexibility to agree site specific arrangements where appropriate. CEPA's report indicates that most incumbents have designed and implemented NAV charges that conform to Ofwats guidance documents. It therefore seems appropriate for Ofwat to continue to manage bulk supply charging arrangements via updates to their guidance document as opposed to developing and introducing new charging rules.

Regarding timing it would seem appropriate to require any significant changes to bulk supply charges, as a result of this consultation, to be effective from 1 April 2021.

Finally, Ofwat need to provide clarity on whether companies should retrospectively apply the changes that result from it amending the guidance on bulk supply charges.

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