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NAV Policy
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By email: NAVpolicy@ofwat.gov.uk

Dear Sir or Madam

CONSULTATION ON BULK CHARGES FOR NAVS

We welcome the opportunity to contribute to the ongoing development of the guidance on bulk charges for NAVs.

CEPA's report has highlighted the challenges associated with providing principles-based guidance and the consequent differing interpretations. We are committed to learning from CEPA's findings and agree that companies should look for opportunities to refine their NAV charges.

Ofwat is requesting views from stakeholders on other relevant issues in the 2018 guidance, but our view is that the nature and cause of the inconsistencies is the result of the very high-level nature of the guidance. While we appreciate and support the reasons for the approach it was inevitable that there would be differences in companies' methodologies, therefore we agree that it is now appropriate to review them with a view to implementing best practice within the guidance.

We have three primary concerns in relation to the proposals presented in the consultation:

- The first relates to proportionality and the trade-off between cost-reflectivity and transparency. We do not agree with Ofwat's view that a bottom-up approach to estimating costs would not be burdensome to administer. In our view it could be disproportionately resource intensive to implement, and potentially create greater variation in charges and a reduced scope to explain the differences than charges developed from generic regulatory accounting data. For transparency, and assurance for stakeholders that all incumbents' start point for avoided costs is the same, our preferred option is a top-down approach.

- Secondly, we do not agree that bulk charges should be discounted to reflect environmental activities that NAVs undertake unless there is clear evidence that the incumbent would avoid cost, for example deferred or avoided investment, and these costs can be quantified. Instead, we are of the view that NAVs should be incentivised outside bulk charges and a targeted incentive that would ensure value for money and equity for customers is preferable, rather than generic discounting of charges. This is an area that we believe would benefit from an industry-led approach.

- Our final concern relates to the proposed timetable for finalising any changes to guidance. Tariff processes generally commence at least six months prior to publication and early certainty on any material amendments to guidance is needed to allow time to implement changes and undertake robust governance processes. The proposed date of December 2020 will not allow companies time to apply anything other than minor changes and therefore we suggest that either the timetable is pulled significantly forward or that any material changes are deferred. Given that companies will be using the CEPA report to help them improve their methodologies for bulk charges for NAVs, our preferred option would be deferral.

Our responses to the specific consultation questions are included within Appendix 1 where we also discuss these concerns further.

If you have any questions please do not hesitate to contact me.

Yours faithfully

[redacted]

Sally Mills
Regulatory Director
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APPENDIX 1

CONSULTATION QUESTIONS

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

We agree that a menu approach to constructing wholesale weighted average tariffs creates greater transparency and accuracy, and we support the proposal for tariffs to be defined this way.

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

To date the usage profile of bulk NAV sites in our area has been below our large user threshold and we have therefore considered large sites only in a hypothetical context. Our bulk charges for NAVs document states that we would assess charges on a site-specific basis and by this we mean that we would consider a site-specific NAV tariff, rather than offer large user tariffs as an alternative. While we understand why in the early stages of market development NAVs may have been offered large user tariffs, we agree that in view of Ofwat's wholesale-minus guidance it is not appropriate to offer them as an alternative to NAV tariffs.

In respect of existing NAV sites on large user tariffs, we believe it is only appropriate for those companies that have such sites in their area of supply to comment on what the future approach should be.

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

We do not agree with the proposal that companies should use bottom-up approaches to estimate costs. Our preference is for a more granular top-down approach and we discuss our views below.

We are fully supportive of a transparent approach which contains audited data and is easy to use. For this reason, we have used Annual Performance Report (APR) data to calculate our tariffs to date. We have understood and reflected in our bulk charges for NAVs document that the approach was likely to overstate some elements of the discount, but as it supported market development this was our preferred option. Our view is that a top-down approach also provides NAVs with assurance that the subjectivity associated with bottom-up approaches is not present. We agree that there is a trade-off between top-down and bottom-up approaches but are more supportive of the former because of the consistency and transparency that is noted in the consultation document.

We disagree with Ofwat's view that it would not be burdensome to administer bottom-up approaches. While companies do have detailed cost information, the subjectivity of developing and applying bottom-up approaches could be more resource intensive than more granular accounting segmentation. Additionally, the subjectivity of company-specific bottom-up approaches could create greater variation in charges and a reduced scope to explain the differences than those that are developed from generic regulatory accounting data. Furthermore, there is a risk that this could adversely impact NAVs.

CEPA observes in section 6.7 of its report that expanding APR reporting to support a 'middle-down' approach could potentially add a significant regulatory burden to companies. We agree with this and would add that in addition to the ongoing reporting burden, there will also be time and cost implications of changing management accounting systems to support such reporting. We would also be against the expansion of the APR in the first instance on the basis that a company-specific approach would allow for best practice to evolve, which could then be incorporated into regulatory reporting if a future review determined that this was required. Expanding the APR too soon would risk time and cost developing systems to collect data that is consequently found to be irrelevant to the process. For these reasons our preference is for all companies to adopt a top-down approach using a starting point of APR data as the basis for calculations, then to use company-specific accounting segmentation that is consistent with Ofwat's updated guidance on bulk charges for NAVs.

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?

CEPA's proposed list appears reasonable and is a useful reference tool, however we believe that it should only be included in Ofwat's guidance on that basis, and not as a specific list of expected deductions. This is because our preferred top-down approach would render the use of the list less relevant, as many costs would be automatically captured.

However, we acknowledge that while the costs are already captured via a top-down approach, further refining them would improve cost-reflectivity. This refinement would form part of the company-specific accounting segmentation we suggest in our response to question 3, and in this respect the list as a point of reference will be useful.

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

We agree that it is reasonable for common costs avoided as a result of NAV entry to be included in avoided costs.

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

We agree that capital maintenance and replacement expenditure should be included in avoided costs but maintain the view that the calculations should be conducted on a top-down basis.

Recognising that avoided costs for individual NAV sites are likely to increase over time we agree that regardless of whether top-down or bottom-up approaches are adopted, incumbent companies will need to consider how to reflect this in charges.

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

As the proposal does not affect us we do not have a strong view, but for consistency for NAVs, it would seem reasonable to maintain the approach until such time that changes to income offsets are implemented.

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

CEPA's analysis in section 6.6 of its report suggests that offering an additional allowance for the rate of return is more likely to be appropriate if the NAV operates a number of sites within an incumbent's area of supply. In turn it could be inferred that an allowance is not as relevant for companies that have low numbers of NAVs operating in their area.

However, CEPA's work also demonstrates that some of the variability between margins is attributable to companies' differing approaches to the WACC and depreciation elements of the current guidance. While this difference in approach was appropriate prior to the changes to the income offset, if in future all companies offered a rate of return allowance, some of the variability may be smoothed and for this reason we agree that it would be reasonable to include. We have considered the four options proposed by CEPA and favour the margin approach due to its simplicity and its alignment with other market approaches, in particular the non-household retail market.

In terms of whether Ofwat's guidance should be less prescriptive, given that CEPA highlight the difficulty in determining an appropriate value and recommends that Ofwat's future guidance is clear in its expectations, we would favour retaining a more prescriptive approach.

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

It is reasonable to expect that tariffs should not create perverse incentives however we do not agree with the proposed wording on the basis that it suggests deliberate intent. Instead, we would suggest that the guidance states that bulk charges should not disincentivise NAVs from offering water efficiency. In our view this would be more aligned to the Government's charging policy objective of environmental protection.

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 do not agree with the proposal for a number of reasons, which we discuss below.

The principle should be that charges reflect the costs. If a NAV undertakes activity that reduces consumption and that leads to reduced costs to the incumbent, then it is right that should be passed into their charges and they should be incentivised to do so.

Any discount should be based on avoided costs for two reasons:

- Firstly, avoided costs are measurable whereas environmental impact is subjective. As such the environmental impact is not transparent for the market.

- Secondly, the environmental impact cost may not, and is unlikely to be, in the current wholesale costs to customers. This is because prices are (in the main) based on actual costs, and not the environmental impact. As such any discount cannot be based on environmental impact as that is not a cost that is currently paid for in the regulatory regime. For example, the full carbon cost of water is not in each customer's bill.

Furthermore, any discount should be based on total reductions in volumes of water supplied and the avoided cost therein, not per capita consumption. In the first instance it is the total volume of water saved that would avoid any upstream cost. Per capita consumption in this context does not in itself avoid upstream costs. Additionally, per capita consumption itself is fraught with calculation error. For example, how can it be established each year how many people actually live in the properties and at what time? Use of per capita consumption, in theory could incentivise over estimation of population to drive down the figure and artificially reduce NAV costs – a market failure in terms of competition. In contrast, if one uses total volume of water supplied, that is measurable and drives competition.

However, as highlighted in the CEPA report:

'The difficulty in assessing these costs may be that any water efficiencies by NAVs would only result in avoided upstream costs for the incumbent over a very longrun time horizon. Experience from other sectors (such as energy) also suggests that it may be difficult to incorporate accurate signals of this type in network charges.'

Whilst a discount may appear appropriate from a theoretical perspective, the calculation in terms of annual charges is likely to be fraught with calculation difficulties and as water demand fluctuates year on year with the weather, any discount may vary as well as what constitutes avoided cost.

As such, if the aim is to reduce demand for water and see those cost savings passed to NAVs, it would seem more appropriate to have a market mechanism that funds the additional upfront capital investment for activities such as grey water re-use. It is that upfront investment that would appear to be the market failure (as water is priced at private costs only not a market or environmental cost in the current regulatory regime). Such an approach would make the market very transparent and reveal the true costs of water to the benefit of NAVs with a level playing field for all.

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

We welcome CEPA's work and consider that it makes a helpful contribution to the development of NAV tariffs. By exposing the level of complexity and range of interpretations of Ofwat's guidance, to us it has demonstrated that for comparability and transparency it would also be helpful to set a relevant starting position for avoided costs in addition to setting a relevant start point for wholesale tariffs. In our view this should be a top-down approach using APR data.

We do not agree that requiring companies to develop individual bottom-up approaches will resolve the issues of variability Ofwat is aiming to address - in fact due to the subjectivity the approach involves we are of the view that it could increase uncertainty surrounding margin levels.

Finally, regardless of whether Ofwat chooses to develop its guidance to require companies to use either top-down or bottom-up approaches, we are mindful that it will require a step-change in approach for at least some companies and the impacts in terms of time, cost and potential incidence effects to NAVs will need to be considered.

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

We recognise the need for industry practice in relation to bulk charges for NAVs to evolve, and for good practice to develop, we agree that the proposed approach in section 4 of the consultation will help support this.

Ofwat's view that it is not appropriate to develop charging rules at this point aligns with our own. As demonstrated by the current consultation and the CEPA report, the current approach of principles-based guidance allows for learning and the evolution of good practice. The implementation of charging rules too early (if at all) will risk unintended consequences to the possible detriment of the market and customers.

We welcome any amendments to the guidance which will improve the clarity of expectations and support best practice, however we are concerned that mandating approaches will inevitably mean that some companies will need to implement significant changes to their methodologies. Phased, deferred implementation of any more material changes, for example the bottom-up or top-down approach to avoided costs, may be better implemented from 2022.This will allow companies to prepare and implement managed transitions in methodology.

Further to this, the proposed December 2020 publication of updated guidance will not allow companies time to either implement anything but very minor changes to their tariff structure or, importantly, follow internal governance processes and engage their Boards on tariff proposals. Tariff processes commence at least six months prior to publication and early certainty is needed on any material changes to guidance.

Finally, we note that Ofwat is considering publishing indicative timescales, which we welcome, but would caution that the wholesale-minus approach means that, to allow for final calculations to be made, NAV tariffs must be finalised after wholesale tariffs. In our view it is not realistic to publish NAV tariffs and wholesale tariffs simultaneously, and we would therefore support a similar timeline to Developer Services Charging Arrangements.