Consultation on bulk charges for NAVs

Southern Water Response August 2020

Thank you for the opportunity to respond to the potential amendments to the NAV bulk charging guidance, originally published in May 2018. Below we have provided some primary comments on the proposals, followed by our responses to the specific questions set out in the consultation.

We support the introduction of competition to facilitate efficiency and innovation in the new connections market. We also support the need for cost reflective bulk tariffs based on a wholesale minus approach of avoided costs. We believe these bulk tariffs should be transparent and not overly complex to ensure a clear, understandable and standardised charging structure.

We are concerned that the proposals to base avoided direct costs on primary cost drivers including property numbers, mains length and other factors, such as the number of pumps and attenuation tanks, will lead to bespoke tariffs for each specific NAV site. This would be undesirable as it would be more complex and would result in complicated billing arrangements for both NAV customers and incumbent bulk suppliers. This would also be contradictory to the guidance published in May 2018 which stated that "setting tariffs on a site-by-site basis would be complex, time consuming and provide no or limited information to NAVs. As a result, in the largest majority of cases incumbent water companies should publish tariff information. It is possible though that, in some (rare) cases, some elements of the charge in relation to a particular site may need to reflect the site's features and/or circumstances and may therefore need to be customised or bespoke"; a principle we completely support.

We would suggest that the principle to publish bulk tariff information and only use bespoke elements in rare and unusual cases, should remain within the guidance. Southern Water has developed a tariff banding structure based on property numbers, which is also a proxy for network length, which provides a greater discount for avoided costs to larger sites. This provides a cost reflective discount for avoided costs without developing bespoke site specific tariffs for each site.

Our experience has also shown that for larger sites, the build profile takes place over a number of years, and in the most extreme cases, over a decade. We would suggest that there should be guidance on how these primary cost drivers should be applied in these cases. Southern Water currently apply the relevant tariff band based on the current number of properties, which is updated regularly to ensure the discount aligns to the avoided costs of the local network. We would not want the avoided cost drivers to be based on the speculative number of properties and network length expected to be completed in future years, and which, in some cases, may never be constructed.

Please find below our responses to the specific questions set out in the consultation on bulk charges for NAVs:

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

We agree that the relevant starting point for the wholesale minus methodology should be the weighted average wholesale tariff based on the actual mix of properties.

Southern Water currently applies the household wholesale tariff as the starting point of the relevant wholesale tariff (which is below that of the standard NHH wholesale tariff) tariff and provides a bespoke tariff where there is a large user on site which would reduce the weighted average wholesale tariff.

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 the large user tariff should not generally be used as the wholesale tariff for NAV sites, and that the wholesale minus approach should apply to NAVs appointed under any criteria. However, there may be circumstances in which the large user tariff is more beneficial to the NAV customer than the wholesale minus approach, in which case we would offer the lower of the two tariffs.

We believe that it is reasonable for wholesale minus derived tariffs to apply to all NAV sites, both new and existing.

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

We believe that either a bottom up approach or the use of granular accounting (middle down) are appropriate means to derive the avoided costs. The exact method should be the choice of the incumbent provided that the avoided costs appropriately reflect last-mile infrastructure.

A pure bottom-up approach may be more burdensome, without producing a more accurate estimate of avoided costs. It is also important to be aware that a bottom-up approach will in almost all cases produce a smaller avoided cost estimate than a top-down approach, as the latter will not include all costs that are bundled in to the former approach.

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?

In general, we support CEPA's list of common avoided costs which we agree should be incorporated into the guidance. There are several activities, such as emergency support and the cost of attenuation tanks for which we would have insufficient cost data. Whilst we would use the cost drivers as proposed, in practice we would convert this to a volumetric discount to align with our tariff structure to ensure simplicity and transparency of charges.

However, we are concerned that the application of the menu based approach to the avoided costs will result in a bespoke tariff specific to each site. For instance, sites will have a different number of properties, pipe lengths, number of pumps and number of attenuation tanks, which would lead to different avoided costs for each site and therefore, specific tariffs for each site.

We would like to understand from Ofwat, if it is the intention for companies to provide site specific tariffs for each development? If this is the case, it is likely that there will be hundreds of different site specific tariffs. This would be contradictory to the guidance published in May 2018 which stated that "setting tariffs on a site-by-site basis would be complex, time consuming and provide no or limited information to NAVs. As a result, in the largest majority of cases incumbent water companies should publish tariff information. It is possible though that, in some (rare) cases, some elements of the charge in relation to a particular site may need to reflect the site's features and/or circumstances and may therefore need to be customised or bespoke"; a principle we completely support.

We would suggest that the principle to publish tariff information and only use bespoke elements in rare and unusual cases, should remain within the guidance.

Furthermore, our experience has shown that for larger sites, the build profile takes place over a number of years, and in the most extreme cases, over a decade. We would like to understand how the primary cost drivers should be applied in these cases. Southern Water currently apply a discount band based on the number of properties, a proxy for network assets/activities, which is updated regularly to ensure the discount aligns to the avoided costs of the local network. We would not want the avoided cost drivers to be based on the speculative number of properties and network length expected to be completed in future years, and which, in some cases, may never be constructed.

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

We agree that incumbents should take account of indirect costs avoided as a result of NAV entry. Such indirect costs should be based on the incumbent's avoided costs, and where these common costs are not avoided or reduced, indirect costs should not be deducted. It is likely that in the vast majority of cases there will be no identifiable avoided costs on a bottom up basis, because of the relative scale of our wholesale business, which determines the level of indirect costs, compared to a single NAV site.

We do not agree that indirect costs should be included purely to increase margins and encourage greater entry by NAVs. However, where costs are avoided, these should be deducted.

We would welcome further guidance on the application of indirect cost avoidance, to ensure a standardised approach across the industry.

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

As stated in our response to question 3, we do not believe that it should be mandated for incumbents to use a bottom-up approach to estimate avoided costs.

We agree that maintenance costs will vary over the life of the assets and we agree with the current guidance published in 2018 that "the incumbent's historical costs could be a reasonable and practical proxy for estimating the ongoing maintenance costs. These costs will cover infrastructure built at different historical times and thus the average maintenance costs could be a reasonable proxy for the lifetime on-site maintenance costs of newly-built assets". Therefore, we believe that a top-down approach is actually more appropriate in this area.

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

No comment.

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

We agree that the rate of return for requisitioned assets is no longer relevant and there are no costs avoided by incumbents. Therefore, the 2018 guidance should be updated to reflect that English incumbents should no longer include a deduction related to the rate of return.

It is not clear what is meant under the heading 'Operational risk'. The cost categories identified by CEPA already include emergency support so to include a separate allowance for operational risk would likely lead to a double counting of these costs. If an allowance for operational risk is to be included then we would need some clear guidance on what should be included in these costs and how they should be calculated.

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

It is unsurprising that companies operating in a competitive market would have an incentive to sell more of their product. Despite the obvious incentives to sell more water, we have not seen any evidence that there is a real problem with NAVs not complying with their statutory obligation to promote water efficiency.

Where there is such evidence we think that is a regulatory or market design challenge for Ofwat, and not one for incumbents to manage through subsidizing NAV bulk charges. We, therefore, do not agree that volumetric NAV bulk charging guidance should explicitly state that volumetric charges should promote water efficiency i.e. provide a lower tariff for low per capita consumption developments.

We currently offer a reduction in infrastructure charges for developments with houses built to water efficient building regulations, which is available to developers and new appointees. This provides an incentive to build properties to water efficient standards and reduce consumer consumption.

We also provide a discount in the bulk charges for the avoided cost of on-site leakage services to new appointees for which they can discharge their license obligations to promote water efficiency and minimise leakage.

We do not agree that a further discount to incentivise new appointees to undertake their license duties is required. Furthermore, such a principle is not provided in the non-household retail market, in which retailers have a greater incentive to increase margins through greater end customer consumption.

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?

As stated above, we do not agree with the principle that NAVs should have discounted *volumetric* charges on lower consumption sites. We believe that the current infrastructure charge discount for water efficient developments is a suitable incentive, and we do not agree that a further discount to incentivise a new appointee to undertake their license duties is required. A lower volumetric rate for on-going lower consumption would, in essence, provide a duplicate financial reward without any additional activity.

In reality, the scale of developments is likely to have close to zero impact on the incumbents supply demand balance or sewer treatment capacity. Incumbents should be able to recover their costs and not be subsidizing new entrants to provide an incentive for them to comply with their licence conditions.

Such an obligation would also add significant complexity and burden to the billing process. Each site would need to be regularly assessed to estimate the per capita consumption. This would involve detailed information on the mix of properties and broad assumptions, and we do not believe this is proportionate and that the benefit outweighs the resource commitment.

A financial incentive for new appointees who implement sustainable drainage systems is currently available. Such sites provide a margin to new appointees through end-customer charges, whilst no equivalent bulk charge is applied for surface water drainage.

We agree that the most environmental benefits are likely to be gained from innovative full service NAV solutions and we support the use of financial incentives and processes to promote such outcomes. Southern Water has an innovative and leading edge programme to work collaboratively with full service NAVS to deliver optimum outcomes for the environment and customers. This involves exploring ways to engage with full service NAVs to understand potential collaborative approaches to service growth demand throughout the South East.

We are also considering a financial incentive to recognise that a full service NAV reduces the impact on Southern Water customers. This is likely to amount to partial payment of the income offset to a full service NAV in recognition of the incumbent's customers' contribution to regional infrastructure. We are currently engaging with full service NAVs to explore this environmental incentive further, prior to formal consultation.

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

It is unclear whether other factors muted in the CEPA report, such as topography and proximity to the coast, would be included in the direct avoided costs methodology and how these could be applied in practice. We would welcome further information on whether these factors are considered material and, if so, we would appreciate further guidance on how such factors would be applied to the avoided costs methodology. As noted above, we would be concerned if the incorporation of such site-specific factors led to the development of bespoke tariffs for every site.

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

We agree with the proposed approach on implementation. We accept that incumbents should review the CEPA findings and apply learning where appropriate. We also agree that introducing charging rules is not proportionate and that an industry led project could help standardise methodologies. We believe that any changes to the guidance should focus on material issues to ensure that it is proportionate to the work involved in updating the charges.

We are, however, concerned with the proposed timescales. Publishing updated guidance in December provides a very short period to develop and consult on new charges based on a new methodology, and which would be due to be published in February 2021.