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1 September 2020

Dear Jeevan,

NAV bulk charges consultation response – September 2020

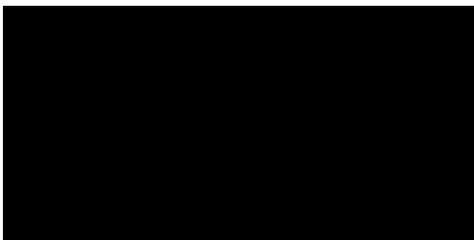
Thank you for the opportunity to provide feedback on the potential changes to the way bulk charges to NAVs are regulated. Our detailed feedback to consultation questions 1 – 12 is enclosed in Appendix 1.

We are encouraged by the content of the CEPA report and in particular the fact that the industry has generally taken well to setting NAV bulk charges in accordance with the Ofwat guidance published in May 2018. We appreciate and support the need to review the guidance in light of CEPA's report and, as set out in our responses to the consultation questions, see significant merit in CEPA's suggestion of maintaining flexibility in the guidance regarding the methods that companies can use when addressing the components of the wholesale-minus approach.

As mentioned in the final question of the consultation, forming an industry-led working group for NAV bulk charges is also something that we see as a positive step which would facilitate incumbents encouraging markets and the alignment of the setting of NAV bulk charges across the industry.

Should you have any questions or comments on our response, please do not hesitate to contact either myself or my team. We look forward to working closely with Ofwat in supporting the ongoing development of NAV bulk charges and competitive markets throughout AMP7.

Yours sincerely,



Nicola Cocks
Regulation Director

Appendix 1

This appendix contains the Thames Water response to consultation questions 1 – 12.

Question 1 - Do you agree with our proposed approach to weighted average tariffs?

We understand and appreciate the rationale behind the menu-based approach being preferable, however for the sake of simplicity and certainty on the NAV's part when trying to gauge the bulk charges they will incur, the weighted average approach that we and a number of other incumbents currently adopt leads to actual bulk charges being published rather than a methodology that NAVs must use to derive the bulk charges.

As per feedback received from NAVs (cited in section 6.1 of the CEPA report), they prefer approaches that are simple and require few interactions with the incumbent to estimate NAV charges. The weighted average approach that we currently use is the most straight-forward and transparent of the options discussed and wholly aligns with the preferences set out in the NAV feedback mentioned above.

Along with two other incumbents, our weighted average is in fact based solely on our residential wholesale tariff i.e. the starting point is weighted 100% to household properties. As of 2020-21, our standard non-household wholesale unit rates (for water volumes up to 20,000m³ per annum and wastewater volumes up to 100,000m³ per annum) are exactly equal to our household wholesale unit rates. Of our existing NAV sites, approximately 97% of properties are household and of the 3% that represent non-household properties it is unlikely that any have annual usage in excess of 20,000m³. Typically, non-household properties on our NAV sites will be small residential units and schools.

While we acknowledge that the fixed wholesale charges applicable to our wastewater service will differ between household and non-household properties, this is likely to have an immaterial impact on overall weighted charges for the vast majority of NAV sites. As such, using the residential wholesale tariff as our starting point seems reasonable and justified as it will likely give the same answer as an approach that considers either a typical or site-specific mix of household and non-household customers.

In summary, rather than supporting the proposal that incumbents are expected to use a menu-based starting point, we support the concluding remarks in section 6.1 of CEPA's report, namely that it may be appropriate for the guidance to continue to allow the flexibility of using the various approaches currently adopted by incumbents.

Question 2 - 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 new NAV sites should be offered only NAV bulk charges and not large user charges as the wholesale minus approach should be applied consistently in the interests of fairness and promoting a level playing field in the NAV market.

For existing sites, we believe that they should be phased off of large user tariffs and onto NAV tariffs for the same reasons as mentioned in the paragraph above. While we have in the past offered both large user and NAV tariffs to existing inset appointees, our NAV bulk charges are now equal to our super large water

and large wastewater rates, thus they are equal to the lowest rates we offer non-household customers. As such, the offering of large user rates to NAV sites that we serve is now a moot point.

Question 3 - Do you agree that incumbents should use bottom-up approaches to estimate costs, or would more granular accounting segmentation be more appropriate?

We agree that where data is readily available, the bottom-up approach to calculating avoided costs provides the highest likelihood that deductions are as cost-reflective as possible. There would however still be an element of aggregation required when using such an approach as it would be preferable to use consistent costings when calculating deductions for NAV bulk charges regardless of the location of the NAV site within our supply area. In reality of course, the costs for such activities vary across our supply region, especially due to the fact that we serve London which brings additional complexity due to density of infrastructure, traffic management requirements and the age and configuration of the networks.

We believe that there is also merit in using a 'middle-down' approach that uses more granularly segmented data from the APR. As it would be based on publicly available data, such an approach will likely provide increased transparency of NAV bulk charges relative to a bottom-up approach that may utilise commercially sensitive information from alliance partners that incumbents may not be in a position to share with NAVs.

In addition, the middle-down approach will be more likely to consistently cover all relevant avoided costs as it would draw on cost categorisations from the APR that capture expenditure for a potentially wider range of activities than may be relevant for the 'last mile' of infrastructure. While this may mean that the avoided cost deduction is overstated (which we appreciate is also the main limitation of the top-down approach), it benefits the NAV (and therefore the end user customer) which in turn should encourage the NAV market to expand and become more competitive.

While easier to implement and calculate for incumbents and NAVs alike, the middle-down approach could also be seen as an implicit means by which incumbents are encouraging competitive markets by using a costing method that sets NAV bulk charges at a slightly lower level than they otherwise could. As the top-down approach applies this rationale to an even greater extent and provides as much (if not more) transparency than the middle-down approach, we do not feel it would be appropriate for the guidance to rule out the use of a top-down approach as its simplicity, transparency and benefit to the market as a whole also has its merits.

It is worth noting that a middle-down approach would need significant changes to be made to APR tables and therefore also to the RAGs, so it is unlikely to be a method that is available en masse to incumbents for a number of years. This provides an additional reason why use of the top-down approach should not be ruled out, at least in the short term.

The CEPA report notes that the top-down method and, to an extent, the middle-down method, lend themselves to a more consistent approach across the industry as a whole, though there is the obvious trade off in cost reflectivity. It is not clear to us that using a bottom-up approach would necessarily reduce the range of margins currently seen across incumbents' NAV bulk charges.

We therefore do not believe that the guidance should rule out any of the currently used methods to calculating avoided costs. We also feel that further consultation should be undertaken to look into the plausibility of the middle-down approach, bearing in mind the potential for a significantly increased reporting burden that it may impose on incumbents through the APR.

Question 4 - 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?

The list seems to cover the activities that we would expect to avoid were a NAV to serve a development instead of the incumbent, however while there is an entry for pumping activities for the wastewater service there is no equivalent avoided cost listed for water service. While it may be unlikely that a NAV site requires a Water Booster Station, for completeness an entry for treated water pumping activities should be included in the list of avoided costs.

Reference to the costs incurred in operating and maintaining non-infrastructure elements of water mains, communication pipes and sewers also seems to be missing from the list, however Appendix B of CEPA's report does mention such assets as being operated by the NAV e.g. water supply and washout valves and chambers. For completeness it may therefore be useful to clarify under the entries for the repair and replacement of water mains, communication pipes and sewers that this also covers any ancillary equipment associated with the infrastructure.

It would be useful to formally include this list in the Ofwat NAV bulk charges guidance so as to provide clarity for incumbents and to increase the likelihood of incumbents using a consistent approach to avoided on-site costs. Such a list should lend itself to being straight-forward to accommodate regardless of whether an incumbent uses the top/middle-down or bottom-up approach to calculating avoided costs. In the case of the former, the APR data used by incumbents is likely to inherently include all of the activities listed while those using a bottom-up approach can ensure all of the activities are explicitly included in their calculations.

Question 5 - Do you agree with our proposed treatment of indirect costs?

We agree with the principle that, so as to ensure NAV bulk charges are as cost reflective as possible, indirect costs that would not be incurred by the incumbent if a NAV served the site should be included in the deductions for avoided costs.

In practice, accurately including a deduction for indirect avoided costs will, as CEPA's report alludes to, prove challenging.

While the incumbents who have adopted a top-down approach will have inherently included an element of indirect costs already (by virtue of the APR data having overheads allocated across the upstream services), we appreciate that this approach is likely to overstate the indirect costs that could be avoided and as such may lead to NAV bulk charges being lower than they otherwise would be. As noted by CEPA, the lower NAV bulk charges generated by this approach may encourage more new entrants into the market.

For incumbents that have used a bottom-up approach, deductions for indirect avoided costs would need to use a much more involved calculation such as trying to distinguish between joint and common indirect costs and then choosing a suitable cost driver to allocate the common indirect costs to activities required on the NAV site.

We therefore agree with the view set out in CEPA's report that the guidance should contain explicit provision for indirect costs to be included in the calculation of avoided costs, but that the guidance should not go so far as to set out a prescriptive method for calculating the indirect avoided costs.

Question 6 - Do you agree with our proposed approach to capital maintenance and replacement expenditure?

We agree that a bottom-up approach to quantifying a deduction for capital maintenance and replacement expenditure is preferable and that the use of an average annuity should be adopted where possible to reflect the variation of such costs over time.

We feel that this element of avoided cost better lends itself to a bottom-up approach when compared to the on-going on-site avoided costs due to the list of relevant assets being very much finite and common to all incumbents. The on-going on-site activities that may be avoided by incumbents is, in our opinion, a more subjective category that could be more open to interpretation. It is however straight-forward to list, without any material doubt, the assets that would be required to operate a NAV site.

Another factor that we believe supports the use of a bottom-up approach for avoided asset replacement costs relates to the public availability of relevant costing information. Incumbents publish prices for the installation of assets such as water meters, water mains and sewers in their 'Charging Arrangements for

New Connection Services'. Self-lay providers likewise publish prices for installing these assets. These published prices can be used to build up asset replacement costs for specific on-site assets. The availability of such costing information therefore provides a bottom-up approach with a high degree of transparency as well as real life cost reflectivity.

Question 7 - Do you agree with our proposed approach to the income offset for Welsh incumbents?

We have no comments to make regarding this question.

Question 8 - Do you have other comments on the rate of return with respect to English incumbents?

We agree with the proposal set out in the consultation and in CEPA's report, namely that the rate of return element of the wholesale minus approach no longer needs to be explicitly included within the deductions due to the revised approach for income offset that now applies to English incumbents.

The detail on a suitable WACC to use for bulk supply returns that was included in the guidance published in May 2018 is, we believe, still very useful and so should not be made less prescriptive even in light of the changes to income offset. The Welsh incumbents will still benefit from the clarity and certainty that the existing guidance provides. Likewise, any English incumbents who need to utilise a WACC that is relevant to a NAV site within their avoided costs calculations will be able to use the prescribed NAV rate of return which will only increase levels of consistency inherent within NAV bulk charges across the industry.

The guidance does however need updating to reflect the relevant NAV WACC that will be applicable as a result of PR19 as the May 2018 guidance references the rate of return applicable during PR14.

We note that, regarding the inclusion of an additional allowance, our chosen approach to deriving a deduction for the avoided on-site asset replacement costs inherently reflects the higher rate of return that a NAV requires to mitigate the level of operational risk that they experience. For example, in our NAV Tariff model for 2019-20, we derived a present value (PV) of the relevant lump sum asset replacement cost using the wholesale WACC relevant to Thames Water (3.60%). This PV was then converted into an annuity using the bulk supply WACC of 4.74% which gives a higher annuity value than that derived when using the lower rate of return applicable to the incumbent. The annuity is then used as our deduction for avoided asset replacement costs.

The result of the approach explained above is that our deduction for avoided capital maintenance costs includes a premium over and above the cost that we as the incumbent would incur if we were running the site and needed to replace the relevant assets. The premium reflects the difference in the rate of return between that deemed appropriate for a NAV operator and that which applies to the incumbent operator.

As such, this approach to calculating avoided asset replacement costs includes a rate of return element over and above that inherent in the incumbent's wholesale tariff starting point (which will have been reduced for the new treatment of income offsets). This, in our view, gives additional merit to using a bottom-up approach when calculating avoided on-site asset replacement costs (see our response to question 6).

Question 9 - Should our guidance explicitly state that bulk charges should not financially penalise NAVs for promoting greater water efficiency?

While we fully support the principle that NAVs should not be financially penalised for promoting greater water efficiency, we feel that care needs to be taken to clarify what is meant by a NAV being ‘financially penalised’, as illustrated below.

As for any commercial company that is not subject to revenue caps, the underlying business model of NAVs is surely based on the premise that, generally speaking, the more units of your product that you sell, the more profit you make in absolute terms. For NAVs, this will be true as the unit rate per m³ that they charge their customers will undoubtedly be higher than the rate the incumbent charges them for the bulk supply (plus any other relevant costs converted to be on a per m³ basis). As such, selling fewer units (in this case m³ of water) will mean lower profits, regardless of the structure of the bulk charges imposed by the incumbent.

On this basis (which appears to be that referenced in section 3.4 of the consultation), every bulk charging structure will, to a degree, ‘financially penalise’ a NAV for promoting greater water efficiency, even those specifically designed to encourage lower water use e.g. rising block tariffs.

The means by and extent to which NAV bulk charges may penalise promoting greater water efficiency therefore need to be considered when adding such a statement to the guidance. So as to not indirectly and unnecessarily restrict the charging structures that incumbents could use when setting NAV bulk charges, we feel that the guidance should require that bulk charging structures do not **explicitly or intentionally** provide a financial disincentive for NAVs to promote greater water efficiency.

For example, if our non-household large user tariffs were applied to NAVs but had the supplementary charges removed, there would be a strong incentive to use more water in order to have a lower unit rate applied to the entirety of the usage. Such a tariff would very clearly financially penalise NAVs for promoting greater water efficiency and so the guidance should make it clear that tariff structures such as this would not be permitted.

In trying to meet a requirement to ensure that NAVs are not financially penalised when encouraging greater water efficiency, there is also a risk that the incumbent may have to reduce the cost-reflectivity of their bulk charges or make them more complicated and less transparent. As such, it would be useful if the guidance made it clear how the various principles that need to be applied when setting NAV bulk charges should be prioritised.

Question 10 - 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 principle that bulk charges should be discounted in instances where the PCC of NAV customers is reduced.

As previously communicated to Ofwat when discussing the impact of Covid-19 on performance commitments, we do not believe that the PCC performance commitment is an appropriate means of incentivising companies to reduce water usage. Our reasons relate to the fact that PCC is largely out of the

control of water companies as it is impacted more by the population data used to calculate it, the weather and Government legislation relating to water efficiency labelling on white goods. If PCC were to be removed as a metric against which incumbents are measured, then no such financial incentive should be made available to NAVs either.

If a PCC-related incentive is introduced, then, as for incumbents, it should be symmetrical i.e. there should be penalties for not reducing it just as there are rewards for reducing it. This will make the implementation of such an initiative difficult as it would be the incumbent's bulk charges that grant the rewards and impose the penalties and it is not the place of the incumbents to be applying what would essentially be a regulatory mechanism.

For these two reasons, we do not agree with the principle that a discount should be applicable in instances where the PCC of NAV customers is reduced. We would be interested to know where NAVs stand on whether a financial incentive to reduce PCC is appropriate given the reasons why we believe it should not be a metric that is financially incentivised.

When viewed in isolation, bulk charges do encourage NAVs to pursue a reduction in PCC i.e. the bulk charges due to the incumbent will be reduced if PCC reduces. The issue for the NAV is of course that the end user revenues also decrease with reductions to PCC. An alternative to incentivising PCC reductions through the bulk charges would therefore be for Ofwat to allow the NAV to increase their end user rates if the NAV can evidence that they have taken steps to reduce water usage amongst their customer base. This would of course need to avoid contradicting the 'no worse off' principle inherent in the NAV regime.

We do agree with the principle that discounted charges should be applicable if a NAV delivers sustainable drainage solutions that reduce volumes of rainwater entering the sewer network. We are in the process of formalising the offering of highways drainage abatements in our NAV charging structure. This will facilitate appropriate discounts for a number of NAV sites that we serve that utilise deep bore soakaways which drain surface water from the entire NAV site. The need to develop our thinking on rainwater harvesting and greywater systems is something that has also been raised recently.

As an aside, highways and surface water drainage services are not explicitly mentioned in the May 2018 NAV bulk charges guidance. There is useful information on how NAVs should be charged for these services in 'New appointments and variations – a statement of our policy' published by Ofwat in April 2015, so it may be helpful to include this information in future publications of the NAV bulk charges guidance.

Question 11 - Do you have other comments you wish to make regarding the methodological issues set out in CEPA's report?

We note that for many of the component parts of the wholesale minus approach to setting NAV bulk charges, CEPA express the opinion that there is no single method that is deemed superior to the other options currently being used. Each option has pros and cons and in many cases the compromise that has to be made is to forgo cost reflectivity to the benefit of transparency and simplicity (or vice versa).

For the majority of the consultation questions discussed above, Ofwat have taken a firmer stance i.e. that companies "should" use or that Ofwat "expect" companies to use a certain approach.

As Ofwat review their guidance in light of the consultation responses, we would encourage Ofwat to consider to what extent they believe requiring companies to follow the specifically suggested approaches will close the gap on the range of margins observed across incumbents' NAV bulk charges. If this is a priority of the potential changes that could be made to the guidance, then Ofwat would need to be comfortable with the possibility that simplicity and transparency are compromised. Such a change would be contrary to the preferred approach voiced by NAVs i.e. the charge estimation process should be simple and require few interactions with the incumbent.

Question 12 - What are your views on how changes to bulk charges for NAVs might best be implemented?

We are supportive of the proposed approach to continue with a NAV bulk charges framework based on Ofwat guidance, refining the content in light of the CEPA report and stakeholder responses to this consultation.

The point made about charging rules being largely unnecessary at this stage given the vast majority of incumbents are following the guidance is a valid one. The publication of the CEPA report now also gives incumbents a very useful resource for considering how they can further align their NAV bulk charges with the guidance and with the rest of the industry. The content of the CEPA report is so comprehensive that when coupled with the updated guidance that Ofwat intend to publish as a result of this consultation, the need for charging rules at this point in time is further diminished.

Per the next steps set out in the consultation, as revisions to the guidance will be made available in late 2020, we would be minded to update our bulk charges for NAVs to reflect any changes to the guidance from 1 April 2021 so as to coincide with the start of the 2021-22 charging year.

We would however like to make the point that publication of revised guidance in December 2020 makes it very difficult for incumbents to set NAV bulk charges and take them through the required governance in time for publication alongside our Wholesale Tariff Document in mid-January 2021. It would therefore be appreciated by all incumbents if the updated guidance could be published as early as possible to allow for sufficient review and implementation ahead of 2021-22 tariff publications.

Finally, we also see the merit in an industry-led approach that could complement the use of the Ofwat guidance and the CEPA report. As noted in the consultation, it would be of particular use to share ideas on how environmental impact could be reduced through NAV bulk charging structures. If, as a result of Ofwat's review of incumbents' support for markets, such an industry-led project on NAV bulk charges is set up, we would be keen to be involved.