United Utilities response to Ofwat's
Consultation on bulk charges for New Appointments and Variations (NAVs)

Introduction

United Utilities welcomes the opportunity to comment on Ofwat's consultation on bulk charges for New Appointments and Variations (NAVs).

We have responded to each of the questions set out in the consultation below and in addition we have made some comments on the CEPA Study "Bulk Charges for New Appointments and Variations (NAVs) Regime in the Water Industry in England and Wales" published alongside the consultation on the Ofwat website.

We continue to constructively engage with the NAV community. NAVs have used these engagement sessions to highlight areas where we could make our charges more accessible and to ask for clarification on our approach. Following the publication of the 2020/21 Bulk Charges for NAVs we met with a number of NAVs to discuss points of clarification and seek feedback on our approach. We will continue to engage with NAVs, as part of our annual review of charges, and consider how best to incorporate their ideas into our bulk charges. In response to feedback from NAVs we continue to develop our approach, this includes wastewater pumping station adoptions, vacant properties in relation to NAV bulk charges and the provision of emergency services. We hope that our commitment to active engagement will help us to provide an environment which allows competition to drive real benefits for all stakeholders.

We also are keen to work with industry stakeholders to consider how best to ensure "full service" NAVs can be satisfied that they are competing on a level playing field.

Ofwat has stated[1] that incumbents should not include existing strategic assets (i.e. treatment works) within infrastructure charges, as reinforcement of such assets is expected to be recovered from the generality of customers. We note that full service NAVs, which provide their own treatment facilities, have indicated to us that they consider that their circumstances are inconsistent with the current approach to infrastructure charges.

We believe that this is an area worthy of further consideration in reviewing the charging rules in order to ensure that these issues are fully assessed. We would be pleased to participate in such a review in the interests of establishing what a satisfactory approach could be given the specific circumstances faced by full service NAVs.

Consultation questions and UU responses

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

We are minded to agree with the use of weighted average tariffs but do not necessarily agree with a site by site based bespoke approach. Our current NAV tariffs reflect a standard tariff, based on typical development sites, for households and non- households (i.e. our NAV tariffs are not site specific). We also only take a site specific mix of those tariffs, if the development includes a mix of large user and household properties. This approach was based on consultation feedback from NAVs.

In our February 2019 consultation[2] with NAVs we specifically asked "do you agree with our proposal to use standardised, rather than bespoke, NAV tariffs?" (Section 3, page 6). All responses agreed with our proposal to use standardised tariffs. One NAV highlighted in their response that a standardised approach

---

[1] Charging Rules for New Connections – decision document December 2016, Section 3.2, page 32.

[2] Section 3, page 6 https://www.unitedutilities.com/globalassets/documents/nav-tariff-consultation-document-final-acc19.pdf

provides more certainty for planning[3]. It was recognised that some sites would benefit and others wouldn't, but that charges across a number of sites would be fair and reflect the costs of new developments on average. NAVs also suggested that the benefit of certainty and a relatively streamlined bulk supply agreement would outweigh the perceived benefits from a bespoke approach.

NAVs want to minimise interactions with the incumbent, as this introduces friction into the bulk service agreement negotiation process. The benefit of reduced interaction and increased certainty of margin outweighs the loss of perfect cost reflectivity on a site-by-site basis.

Based on feedback from our stakeholders on Bulk charges for NAVs we moved to a regional weighted average approach but retained a menu option where a site was likely to vary significantly from standard assumptions. This approach makes it much easier for NAVs to administer.

If we are required to move to the menu-based approach in subsequent updated Ofwat guidance we will implement the bespoke average, on a site by site basis, tariff but it should be noted that we expect this to be contrary to the expressed wishes of NAVs as communicated to us.

A further consequence of Ofwat's proposal is that it will result in an increased number of transactional touch points with NAVs, which we understand is something they would prefer to avoid in the interests of reducing transaction costs. As communicated to us, speed is a key factor in determining a NAV's success in the new connections market. A bulk charge that uses site specific information provided by the developer might result in a more cost reflective charge (higher or lower on a site by site basis), but if the process of generating a charge generates additional exchanges of information between the NAV and the developer then these added frictions may outweigh any benefits where cost reflectivity would have indicated a lower charge. Furthermore, to the extent that NAVs value certainty (to facilitate planning) rather than strict cost reflectivity for individual sites, the burden of administering a more cost reflective (in terms of site-specificity) NAV bulk supply tariff may alone be a barrier to entry.

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 do not agree that for new sites the only bulk charges option that should be offered to NAVs is the wholesale minus approach.

There may be certain NAV sites where the wholesale minus approach may result in a lower discount than a company's wholesale charges for large user customers. We would be concerned that NAVs may consider that a larger development should not be charged more than a non-household customer that uses an equivalent amount of water. Whilst we recognise this approach is not in line with Ofwat's guidance in applying a "wholesale minus" approach, nonetheless it is difficult to disagree with the legitimacy of charging a NAV the "lesser of" the NAV charge and the company's wholesale charges.

An independent third party review of our NAV tariff arrangements supported that our methodology represented a good approach to mitigation of competition law risks relating to the margin available to NAVs and that we have taken mitigating steps that offer a reasonable line of defence against potential

[3] Section 3, page 2 https://www.unitedutilities.com/globalassets/documents/pdf/uu-statement-on-consultation-responses-final.acc19.pdf

allegations of a margin squeeze. We are therefore reluctant to move away from our existing methodology of offering the "lesser of" the NAV charge and the company's wholesale charges.

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

We agree with the proposal to use a bottom-up approach to estimating costs as this best reflects the actual avoided costs of operating last-mile infrastructure and is less burdensome to implement when compared to a top-down approach. We have engaged with NAVs to help identify relevant on-site costs that a NAV would face, and we believe that the bottom up approach best reflects these costs.

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 the CEPA list of common avoided costs and note that we include all of these in our bulk charges for NAVs methodology.

We believe that the list should also include costs associated with managing interactions with the Non-household Retail Market. These costs are recovered from wholesale non-household tariffs (the starting point) but should not be recovered though NAV charges.

Consideration should also be given to how vacant properties are treated with regards to NAV bulk charges. This is not an issue for volumetric charges, but is an issue for fixed Surface Water Drainage charges which are due for each property connected to the incumbent's sewer network. If the incumbent were to charge the NAV for each connected property regardless of whether a property was occupied or vacant, then the NAV may not be able to fully recover these costs from their customers if the site is not fully occupied. This does not affect any existing contracts, as there are no NAV sites currently connected for Surface Water drainage, but could hypothetically affect future contracts.

We have identified four potential options for consideration:

1. Levy a fixed charge for each connected property. This ensures that the incumbent fully recovers the costs of providing the service but creates a risk the NAV is unable to fully recover this cost from their customer base
2. Levy a fixed charge for each occupied property. This would require a high level of administration on behalf of both incumbent and NAV to determine the level of occupation for a NAV site and to refresh the bulk NAV charge on a period basis to adjust for the level of occupancy
3. Levy a fixed charge for each connected property, but to include an additional fixed discount within this charge to allow for the average percentage of vacant premises for a typical NAV site. This would provide a fixed % discount for all NAV sites, as opposed to a bespoke discount based on the actual number of occupied and vacant properties
4. Charge NAVs for Surface Water Drainage based on volumes (e.g. from the water meter) instead of a fixed charge per property. This would help ensure that NAV charges are proportionate to the level of occupancy / usage, but is a significant deviation from the wholesale charging structure.

We suggest that option 3 above would be the most appropriate approach, as this would address the issue, whilst best satisfying feedback from NAVs that they prefer to avoid unnecessary contact with the incumbent. We would welcome clarity on this matter in the NAV charges guidance.

The tables below show costs in the CEPA report and compare them to costs included in the UU NAV charges methodology. The tables also include an additional cost which are in the UU NAV charges methodology but not in the CEPA report.

CEPA Report	UU NAV Charges
Water quality sampling	Included
Regulatory compliance	Included
Leakage detection	Included
Mains repair and replacement	Included
Communication pipe repair and replacement	Included
Mains cleaning	Included
Emergency support	Included
Meter space	Included
	NHH Retail Market costs

CEPA Report	UU NAV Charges
Sewer repair and replacement	Included
Sewer cleaning	Included
Emergency support	Included
Pumps	As required
Storage and attenuation	As required
	NHH Retail Market costs

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

We agree with the proposed treatment of common (indirect) costs.

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

We agree with the proposed approach to capital maintenance and replacement expenditure.

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

We agree with the 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?

We agree with Ofwat's view that English incumbents should no longer include a deduction through the rate of return element because these costs are no longer avoided by the incumbent.

We also agree that any additional allowance should reflect the operational risk experienced by NAVs to operate on-site assets which the incumbent has avoided. This aligns to our current approach where we include a profit allowance in the NAV tariff. In addition to the working capital deduction, we include an allocation of normal profit to reflect the business risk faced by the NAV.

In addition, we recognise that there is some avoided capital in the form of end user customer meters. We compensate NAVs for capital invested on-site by providing 100% discount for the meter standing charge component of the water service charge.

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

We would be content for Ofwat to introduce guidance explicitly stating that bulk charges should not financially penalise NAVs for promoting greater water efficiency.

Our standardised approach to NAV charging already achieves this, as discounts are based on an assumed (regional average) level of consumption per property. Therefore our NAV volumetric rate discounts do not reduce if the NAV delivers greater levels of water efficiency – it remains the same. However, if Ofwat implements its proposed approach set out in question 1, this would lead to more site specific assumptions being used, which would seem to penalise NAVs for promoting greater water efficiency, as discounts would reduce as a result of any site specific reductions in water use.

Therefore, we consider that our approach of a single regional discount based on regional averages is more consistent with such a statement being 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?

We agree with the principle of providing price signals to support water efficiency. As stated in response to question nine, our standardised approach to NAV charging already (effectively) achieves this, as discounts are based on an assumed (regional average) level of consumption per property. Therefore our NAV volumetric rate discounts do not reduce if the NAV delivers greater levels of water efficiency – it remains the same. This therefore provides a natural additional discount for NAVs that deliver greater water efficiency.

However, if Ofwat implements its proposed approach set out in question 1, this would lead to more site specific assumptions being used, which would seem to penalise NAVs for promoting greater water efficiency, as discounts would reduce as a result of any site specific reductions in water use. In that case, an additional mechanism would be required if Ofwat sought for NAVs to be in receipt of additional discounts. This would seem unnecessarily complex in comparison with our existing approach, which NAVs support and provides a natural incentive for water efficiency.

Therefore, we consider that our approach of a single regional discount based on regional averages is the simplest and most effective mechanism to achieve better incentives for water efficiency, an approach which is also supported by NAVs.

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

We have no additional comments to make regarding the methodological issues set out in CEPA's report.

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

We agree with Ofwat's position that bulk charges continue to be set in line with guidance rather than prescriptive charging rules at this stage. This will continue to allow a degree of flexibility for incumbents and NAVs to agree arrangements for particular sites.

Bulk Supplies are also managed and are appealable under section 40 of the WIA91.

In section 1.2.2 of the consultation (page 5), Ofwat indicates that it expects the determination powers under sections 40, 40A, 110A and 110B of the WIA91 to remain, even if Ofwat moved towards setting charging rules for Bulk Supplies for NAVs. However, it is not clear to us how that would work - in particular, if an Ofwat determination under those sections concludes a different price from that set under charging rules, and published in an approved charges scheme, it is not clear how that might set a precedent for other customers' charges under that scheme (or any historic schemes impacted on by the determination). Until that process has been fully clarified, we consider that Ofwat should continue only to set guidance for NAV bulk charges.

We also acknowledge the improvements delivered through the NAV market improvement project and would continue to support industry-led approaches to delivering improvements. If operated appropriately, industry collaboration through "working groups" can make useful contributions towards greater consistency and clarity amongst the parties involved. A current example of a successful working group from the water sector is the NHH water retail market's Retailer Wholesaler Group (RWG). It supports the NHH retail market, allowing trading parties, regulators and consumer groups to work together.

Based on the experiences from the RWG work to support the NHH retail market we would recommend that discussions should be tightly limited to exclude straying into areas that must remain the sole responsibility of the individual companies. Discussion could include: standardisation of terminology and definitions; worked examples of the different forms of charging; a structure to guide the form of publication of charges. The methodology for calculating charges and cost allocation – on the other hand – should in our view remain the responsibility of individual water companies and their Board. We are concerned that clarity over responsibilities remains essential in a dynamic charging environment.

In relation to timescale for implementation of any changes, we need to understand what the level of accommodation will be and which changes would be phased in versus implemented more immediately. Timescales need to reflect both an opportunity to engage with NAVs on the impact of their charges and consideration being given to existing NAV sites and options around transition where changes to the guidance results in changes to existing tariffs. Our assumption is that we will continue to offer existing

NAV sites the choice to move onto the new arrangements if they want to but we would not require an immediate transition for those who do not.