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7 September 2020

Dear Ofwat,

Re: Consultation on bulk charges for New Appointments and Variations (NAVs)

Thank you for the opportunity to review and provide feedback on the potential changes to how you regulate the bulk supply or discharge charges paid by NAVs to incumbent water companies. We also welcomed the publication of the study on bulk charges for NAVs carried out by CEPA.

We have reviewed the study findings and Ofwat's proposals relating to:

- The bulk tariff relevant starting point;
- Estimation of avoided costs;
- The rate of return element, and;
- Environmental impacts.

We found the CEPA report very interesting and many of its recommendations are already in place within our bulk charging arrangements in some capacity. Our arrangements are distinctly reflective of costs, as we use a number of cost drivers applicable to the specifics of each NAV site to determine charges for the bulk supply of water and wastewater services.

We also engaged with NAVs and other stakeholders throughout the development of our charging arrangements and have published our consultations and decisions on our website for reference. We of course will continue to seek to make improvements in transparency of our charges and the key cost components so that NAVs can have confidence in the arrangements and understand they are fair for them and our customers more widely.

As the incumbent company in our region, we understand we have special responsibilities under competition law, and we consider the effects on competition from our charging arrangements, not simply whether we align well to Ofwat's guidance. We welcome greater entry of efficient and effective NAVs and are very interested to see how NAVs can provide differentials to service or price (or both) to benefit the people of Yorkshire they serve.

We append our responses to the consultation questions to this letter below. We note that should Ofwat decide to revise its current guidance on bulk charges for NAVs, that it will consult on the details later this year. We welcome the opportunity to participate in any further engagement on this subject with Ofwat either directly or through any sector-led working group.

Should you have any questions in relation to this response you can contact me by email at: colin.fraser@yorkshirewater.co.uk.

Yours faithfully,

[redacted]

Colin Fraser
Regulatory Strategy Manager

Yorkshire Water Response to: Consultation on bulk charges for New Appointments and Variations (NAVs)

Bulk tariff 'relevant starting point'

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

As described in the consultation, we follow the commonly used menu-based approach to determining the weighted average starting point tariff for the relevant NAV site. In our experience we have found this to be straightforward for the vast majority of sites in our area. Where the site has multiple non-household properties and it is unknown what business types will occupy these properties once built, we appreciate NAVs may have to be broad in their estimates of expected water use and/or sewerage discharge.

The NAV and the incumbent are not locked into the bulk tariff used initially in the bulk supply agreement. Tariffs and charges can be, and are, reviewed and revised. For example, where the incumbents wholesale tariffs change or material changes to water and sewerage use are evidenced.

We would prefer to continue with our singular approach. We do not think it appropriate for the NAV to demand on a site by site basis either a site-specific menu-based approach or an *ex-ante* regional average site average approach to the starting point for the bulk charges.

We therefore agree with your proposed approach for incumbents to use the site-specific menu-based approach when defining relevant wholesale tariffs.

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 wholesale large user tariffs should not be offered for new NAV sites. We do not consider such tariffs to be a detailed reflection of the incumbents' costs of providing bulk services to NAV sites and the range of avoided costs.

Estimation of avoided costs

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 CEPA's and Ofwat's assessment of the three main approaches employed in estimating avoided costs and the conclusion that in the round a bottom-up approach is preferable as it has a greater potential to be more cost reflective.

Currently we use a mix of approaches based on the most reliable and consistent information we have and the cost differentials of each approach for the key avoided cost components. We intend to work towards a wider use of the bottom-up approach for our bulk charges for NAVs as this aligns well with our existing site-specific tariff methodology.

We do not consider it appropriate to publish more granular water and wastewater network cost information in the Annual Performance Report, as we believe this would make the APR from companies more complex, lengthy and impenetrable for many stakeholders.

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 the CEPA list covers the key activities incumbents avoid where a NAV adopts and maintains/renews the local 'last-mile' water and/or sewer network. We believe the lists cover both the main elements from scale of costs avoided and frequency of activities avoided.

There are no elements listed by CEPA that we do not detail in our NAV bulk charging arrangements. It may be a point of granularity, but we also list the avoided costs for sewer adoptions (possibly considered by CEPA as an overhead), and supply pipe repairs (customer owned pipe but repair actioned free of charge).

For more complex and less common costs associated with a local network, such as pumping stations and storage and attenuation, we exclude these avoided costs from our bulk charges model. We will treat assessment of avoided costs for such operating and maintaining such assets on a case by case basis against a number of cost drivers, such as number of pumps, expected power usage of pumps, etc.

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

We agree with the proposed treatment of indirect costs in that such estimates should be based on the incumbents avoided costs. Presently, we take a top-down view of the application of indirect costs into our bulk charges model and we will assess whether this approach is sustainable as part of our annual review of our bulk charges to see if this approach continues to best serve NAVs and other stakeholders in our region.

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

We also agree with the proposed approach to capital maintenance expenditure on assets replaced over time. We presently account for such future expenditures in our charges for NAVs and apply these avoided costs as an averaged annuity.

We will review the details of how we treat such costs in detail when we appraise our bulk charges annually.

Rate of return element

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

We have no comments to make on the proposed approach for Welsh incumbents.

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

Our charges for new connection services have not included income offsets for a number of years and as such we did not made any deductions for NAVs through the rate of return element for funding such components of new connection charges. We have always assumed in our region NAVs on-site assets are fully funded by developers up front or very close to when the expenditures are incurred.

We do account for estimated expenditures in replacing assets many years in the future as costs avoided by the incumbent as we assume the NAV will continue to maintain and operate the local network in question.

We have closely followed Ofwat's 2018 guidance in setting a suitable NAV relevant rate of return for NAVs. Ahead of the 2018 guidance being published by Ofwat, we commented in our consultation response that we thought "*the incumbent WACC may be appropriate as a starting point with a small company adjustment as per Periodic Review determinations*". We did not think it necessary to set a rate of return for NAVs that was significantly different to that of incumbents. However, on balance we were happy to follow the guidance as published with the NAV WACC as indicated. For this year we updated the WACC (or discount rate) we used in our bulk charges based on maintaining a similar differential to the incumbent WACC set in the PR19 Final Determinations. We may review the detail of our approach in future.

We welcome that the guidance provides a framework for how a rate of return for NAVs is considered and treated across incumbents and provides understanding to NAVs. We believe the guidance should continue to inform and guide incumbents in this area on a principle's basis.

Environmental impacts

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

We do not believe in our region, and possibly in many others, that bulk charges create a strong incentive for NAVs to increase water consumption despite the differential between bulk charges and retail tariffs being based on volume.

We see the actions of NAVs run contrary to that thinking.

1. As Ofwat will be aware, some customers of NAVs in our region will expect to see benefits in the price they pay compared to the price cap the NAV could use, reducing the potential volumetric price differential and hence margin the NAV could achieve.

2. The developers themselves continue to be incentivised to install low water use features in the houses they construct via the transfer of the environmental incentives we offer through discounted infrastructure charges.

3. As water undertakers, NAVs are required under the Water Industry Act to promote water efficiency with their customers. Should NAVs not promote water efficiency or

indeed promote water inefficiency this would run counter to an enforceable condition under the Act.

4. Perhaps encouraged through the bulk charge to retail tariff differentials, NAVs aim to manage leakage effectively and efficiently on their networks. We have observed in many NAV publications targets for low levels of leakage compared to that experienced or targeted by incumbent's water undertakers (with the incumbents mix of very aged and modern networks) without recourse to comparative performance commitments and ODI's.

5. The government has committed to set an ambitious personal water consumption target in the 25 Year Environment Plan. Defra is considering an Environment Bill target on overall demand for water which could reflect both water lost in leakage and a new target on per capita consumption. Alongside options to amend existing building regulations and rollout water efficiency labelling which the whole sector could benefit from, we see NAVs being an integral part of the solution not part of the problem.

We consider including a broad and possibly opaque statement in the bulk charging guidance aimed at incumbents somehow setting bulk charges that will not financially penalise a NAV where it promotes water efficiency to be unnecessary and unhelpful. It would be very difficult for an incumbent to evidence to the affirmative without understanding in great detail the promotional activities employed of each NAV, its associated costs and post promotional impacts on the water use of its customers.

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 reflected in our response to **Q9.** above, we do not agree that NAVs should have further discounted bulk charges if they deliver lower per capita consumption or reduce foul water or surface water volumes beyond the incentives already available to them or their customers (developers and end consumers).

It should be within each incumbent's discretion to include or not, financial incentives or other mechanisms to incorporate NAVs within its plans to address environmental protection and improvement and build ever more resilient and sustainable water resource plans and drainage plans. It remains for incumbent companies to consider any consequential impacts or potential inequities across their customer base from their bulk charging arrangements and charges schemes and to ensure they continue to meet their Competition Act obligations.

We would welcome a broader discussion with Ofwat and the sector around the regulatory framework in general and any perceived disincentives from efficient entry by NAVs with different business models.

General

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

We found CEPA's report well structured and interesting. We identified with many of the observations made from the evidence and information provided to it from companies and concurred with many of the views expressed in the report.

Beyond the points detailed in our above responses, we have one further comment on an issue set out in CEPA's report, that being the application of a leakage adjustment to bulk tariffs to reflect the expected volume of water losses between the bulk supply meter and the end-consumers' meters (only where the NAV is charge based on bulk metered volumes recorded at the network boundary). We agree with CEPA that this is one area that may benefit from more explicit guidance from Ofwat on how such adjustments are to be estimated and applied when Ofwat is asked to determine the terms of a bulk supply.

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

We note the indicative timetable for consultation and conclusion of changes to the bulk guidance, should Ofwat decide to make amendments. We also agree with Ofwat that the speed with which incumbents review and adopt as relevant such changes into their bulk charging arrangements is critically important for NAVs and their plans and opportunities.

We also agree that the sector-led NAV market improvement project has been invaluable in making good progress at pace around some key market frictions and ensured consistency of approach in many areas of the incumbents' formal arrangements with NAVs.

In our experience, we do not see that progress has been hampered specifically by an overly reluctant approach from incumbents to collaborate and discuss improvement options and greater consistency based on their caution around managing competition issues. In it's 'Review of incumbent company support for effective markets', published on 11 August 2020, Ofwat highlights a common theme by incumbent companies *"…in our view wrongly, using competition law as reason not to collaborate or as reason not to be more responsive of the needs and specific circumstances of individual market participants*". In regard to the development of our bulk charging arrangements for NAVs we consulted widely, sharing options and our preferred approach in detail both with NAV clients and also other water companies. We understand a few other water companies did likewise.

We continue to support the sector-led initiatives and liaise regularly with our NAV clients around our bulk charges and charges for new connection services. We are also encouraged by the wide adoption of the latest industry standard bulk supply and discharge agreements.