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Bulk charges for new appointees – our conclusions

Ofwat

About this document

We consulted on potential changes to how we regulate the **bulk supply or discharge charges paid by new appointees** (also known as NAVs or small companies) to larger water companies (**incumbents**) on 13 July 2020. The July 2020 consultation principally related to applying best practice in the calculation of cost-reflective bulk charges.

This document summarises the views provided by respondents to our consultation and sets out our conclusions and next steps.

Bulk supplies or discharges can be between incumbents or between incumbents and new appointees. This document relates to bulk supply or discharge agreements between incumbents and new appointees, not between incumbents.

Because the NAV framework applies to both England and Wales, this document relates to incumbents wholly or mainly in England (**English incumbents**) and incumbents wholly or mainly in Wales (**Welsh incumbents**).

Revising our guidance on bulk charges

Alongside this document, we are also consulting on a revised version of our guidance on bulk charges for new appointees. We intend to finalise our revised guidance informed by stakeholders' views in January 2021.

We will publish the revised version of our guidance on our website.

Contents

1. Introduction

1.1 Document purpose and structure

We published guidance on bulk charges for new appointees in May 2018 (our **2018 guidance**). It set out how we would approach future requests to determine the bulk charges paid by new appointees to incumbents, in particular by using a **wholesale minus approach**. We also said that incumbents should publish their bulk charges in line with the guidance.

Following implementation of our guidance, we commissioned a report from economic consultants CEPA into incumbents' practices when setting bulk charges for new appointees. We found that as a result of our 2018 guidance, new appointees are now much better placed to calculate what their bulk charges would be when considering whether to bid for new sites. We also found, however, that in many cases the methodology for calculating charges was unclear, and may not be cost reflective.

This led us to consult on our approach to regulating bulk charges paid by new appointees in July 2020. The consultation related principally to the application of best practice in the calculation of cost-reflective bulk charges, using the wholesale minus approach. We explained that we expect the application of best practice to reduce the large variation in margins that we had seen. In addition, we consulted on how to ensure that bulk charges support better environmental outcomes associated with the sites served by new appointees.

In the new appointments and variations market, we want to see bulk charges that are more transparent and cost reflective, and we think that there would be benefits from greater methodological consistency and sharing good practice. Through timely and effective support, incumbents and new appointees should also facilitate a level playing field to the benefit of customers, the environment and wider society.

This document summarises the views provided by respondents to our consultation and sets out our conclusions and next steps.

The rest of this document is structured as follows:

- in the remainder of this section we set out how this documents fits within the wider context of our strategy and related policy and regulatory developments;
- an overview of our **July 2020 consultation**, including a summary of CEPA's findings and our proposals (section 2);
- the **key methodological issues** covered in our consultation and raised by stakeholders, with our assessment and decisions (section 3); and
- how we propose to **implement our conclusions** (section 4); and
- our **next steps** (section 5).

1.2 Our strategic objectives

A well-functioning new appointments and variations market can deliver for customers in terms of increased choice, efficiency and innovation, as well as improved outcomes for the environment and wider society.

The new appointments and variations framework is consistent with our wider approach to promoting the targeted use of markets to benefit customers. Within this context, we continue to develop our thinking, particularly relating to bulk charges given its key importance to the effective operation of the new connections market.

As we set out in our strategy, competition and markets can deliver significant benefits for the water sector by bringing about cost efficiencies and encouraging higher service levels, while also incentivising innovation.

By continuing to examine ways to encourage markets for new appointments and variations, we aim to:

- **transform companies' performance** – by enabling the development of markets where they can bring the biggest benefits to customers, facilitating greater innovation and better value for money for customers;
- **meet long-term challenges** – by promoting collaboration and partnership between stakeholders, supporting improved sustainability and the delivery of environmental and nature-based solutions; and
- **provide greater public value** – by holding companies to account for the services they deliver, encouraging better value for money and that all market participants deliver more for customers, society and the environment.

1.3 Recent policy and regulatory developments

Since we published our 2018 guidance, which followed from a report by Frontier Economics into the new appointments and variations market, there have been a number of key developments in the sector:

- changes to the 'income offset' in our new connection charging rules for English water companies that came into effect from 1 April 2020 with the consequence that developer customers of English companies now fully fund the construction of on-site assets, thereby largely addressing a key barrier for new appointees;
- the industry's NAV market behaviour improvement project has responded to challenges identified by Frontier Economics' report, leading on the development of new service metrics and standardised bulk supply agreement templates for new appointees;

- we published a consultation on new connection charges for English incumbents in May 2020, which identified variations between incumbents' charges and proposed an industry-led working group to drive improvements;
- in August 2020 we concluded our review of incumbents' support for effective markets. We found incumbents' support for new appointees improve during our review, with a number of incumbents improving the information that they published and their engagement with new appointees. Since publishing the review, we are pleased that a number of incumbents have contacted us explaining what actions they are taking to further support markets, including for new appointees; and
- in September 2020 we concluded on changes to the developer services measure of experience (D-MeX), as part of which we incorporated financial incentives that relate to the levels of service incumbents provide to new appointees.

There have also been changes to the legal framework for regulating bulk charges paid by new appointees over recent years. The Water Act 2014 now enables us to set charging rules with respect to bulk supplies and discharges in addition to the existing determination powers we have under sections 40, 40A, 110A and 110B of the Water Industry Act 1991. We can currently only set charging rules in relation to agreements between English companies (since 1 April 2018) and between Welsh companies (since 1 April 2019).

If we were to develop charging rules, we must have regard to guidance issued by the UK and Welsh Governments. Guidance relating to overall charging principles as well as bulk charges have been issued by the UK Government (see 2016 and 2018 guidance) and the Welsh Government (see 2017 guidance).

As we emphasised in this year's review of effective markets, incumbents have an important role to play in supporting markets to be effective and ultimately deliver for customers. Beyond following our guidance or directions, incumbents should be actively considering how to support markets, including by refining and improving their processes when interacting with new appointees.

2. Our July 2020 consultation

2.1 CEPA's report

We published CEPA's report alongside our July 2020 consultation. CEPA found that with respect to adopting the wholesale minus approach and publishing tariffs, overall there was a good level of compliance by incumbents.

However, CEPA also found a wide range of approaches and assumptions used by incumbents leading to a wide variation in a prospective new appointee's estimated wholesale operating margins that were unlikely to be solely explained by underlying cost characteristics.

2.2 Our proposals

In our July 2020 consultation we considered some of the issues raised by CEPA and set out proposals for how they may be addressed.

We were particularly concerned that the range of different approaches used by incumbents to set their bulk charges may be a significant cause of the high variation in the wholesale operating margins available to prospective new appointees estimated by CEPA.

We asked for stakeholders' views on the following key issues relating to the setting of bulk charges for new appointees:

- the **relevant starting point** – we said we expected companies to use a menu-based approach when defining relevant wholesale tariffs, and that incumbents should not offer 'large user tariffs' to prospective new appointees;
- **avoided cost estimation** – we stated a preference for incumbents to use bottom-up approaches to estimating their avoided costs, clarified that indirect costs should be accounted for, and sought views on an approach to capital maintenance expenditure;
- the **rate of return element** – we discussed the impact of changes to the income offset on English incumbents and sought views on whether an additional allowance for new appointees was appropriate; and
- **environmental impacts** – we sought views on how incentives to promote greater water efficiency and improve environmental outcomes could be practically reflected in bulk changes.

We also consulted on how to implement some of these changes. We said we did not consider developing charging rules to be a priority at this stage and proposed to revise our guidance later in 2020 to enable incumbents to reflect changes in their charges for new appointees in early 2021.

We also said that it was important for incumbents to review the findings of the CEPA report and its relevance to their bulk charges.

In addition, we noted that an industry-led approach to delivering improvements had merit and could consider aspects of bulk charges for new appointees.

2.3 Overview of responses

We received responses from 21 stakeholders to our consultation, which was open from 13 July to 7 September 2020. We publish these responses in full on our website.

Respondents include 16 large incumbent companies, three new appointees (Icosa Water, Independent Water Networks and Leep Water Networks), the Consumer Council for Water (CCW) and Waterscan.

3. Key methodological issues

In this section, for each key methodological issue we summarise our consultation proposals and respondents' views, before setting out our decisions.

As we set out in section 4, some of these issues will be progressed through revisions to our guidance while for others we expect incumbents to take our assessment into account when developing their bulk charges, or for the proposed industry-led group to take this forward.

3.1 Relevant starting point

3.1.1 Weighted average tariffs

What we said in our consultation

We said we expect incumbents to use a menu-based approach that reflects the actual mix of properties on a site when defining the relevant wholesale tariffs to use when setting their bulk charges for new appointees.

Respondents' views

Seventeen respondents agree with our proposal.

Thames Water and United Utilities say they prefer existing *ex ante* weighted average approaches, where the relevant starting point is based on a typical development site, arguing such approaches are preferred by new appointees due to their simplicity and predictability.

Of the new appointees, Independent Water Networks agrees with our proposal, preferring cost reflectivity despite the added complexity that may arise from site-specific charges while Leep Water Networks suggests both approaches could be offered. Both respondents request 'tariff calculators' to enable new appointees to independently ascertain bulk charges for prospective sites.

Icosa Water proposes a new approach based on aggregates of end user meter readings arguing this would be simpler to administer than menu-based or weighted average approaches.

Our assessment and decisions

We consider menu-based approaches which accurately reflect the characteristics of an individual site are the best way for incumbents to remain consistent with our guidance, particularly as new appointees grow, potentially innovate the services they provide on a site, and the number and mix of properties on a site vary over time. As such, we continue to consider that a proportionate menu-based approach is important for most incumbents to adopt, particularly where their current approach does not allow them to reflect and vary the starting point of their wholesale minus approach on the basis of a site's characteristics.

Some incumbents currently adopt alternative approaches, such as assuming that all premises are households. We can see the benefits of maintaining such approaches in the short term, for instance where this has been subject to consultation with new appointees and facilitates timely agreements. However, we anticipate that these practices will evolve to menu-based approaches over the next two years.

We will revise our guidance to reflect our expectation that incumbents should use menu-based approaches when defining the relevant starting point of their bulk charges

To further support the effective development of the new appointments and variations market, incumbents should provide the means for prospective new appointees to independently estimate their charges for example through the use of tariff calculators and worked examples. CEPA has identified examples of good practice in this area that incumbents should look to replicate.

In terms of a new approach based on end customer meter readings, we consider this would be a major change to our existing approach, would remove incentives on new appointees to manage leakage, and would require further consideration. We do not intend to incorporate such an approach in our guidance at this stage.

3.1.2 Large user tariffs

What we said in our consultation

We noted that we had observed that some incumbents offer 'large user tariffs' to new appointees as an alternative to charges based on the wholesale minus approach.

For new sites, we considered that incumbents should only offer bulk charges based on a wholesale minus approach for all new appointments or variations appointed under any criteria (consent, unserved or large user).

We also sought views on the approach for existing sites.

Respondents' views

New sites

Thirteen respondents agree and four respondents partly agree with our proposal that incumbents should not offer large user tariffs to new appointees seeking to serve **new sites** now that the wholesale minus approach is established.

Severn Trent Water says it supports our proposal provided we are satisfied it does not represent discrimination against new appointees.

Four respondents, including three new appointees, disagree with our proposal, arguing that large user tariffs should remain available to new appointees if the resulting charge is lower than a charge estimated under the wholesale minus approach on the basis that it may be more beneficial for new appointees, may mitigate competition law risks, or until further work has been undertaken to examine their applicability.

Four respondents note that large user tariffs may be appropriate for sites appointed under the 'large user' criterion[1] where the new appointee only serves a single large user of water because there would be no avoided wholesale costs for the incumbent (and so the charge is likely to be the same) or because a new appointee would be expected to offer an equivalent tariff to its relevant customers.

Existing sites

For **existing sites** served by new appointees, two respondents consider charges based on the wholesale minus approach should apply to all existing sites, while eight respondents consider that existing sites should transition to charges based on wholesale minus approaches, taking account of contractual arrangements with new appointees, with any changes to be optional until existing contracts expire.

Three respondents consider current charges should be retained, with CCW noting that forcing a change could affect the financial viability of existing sites.

Severn Trent Water comments there may be transitional issues for existing sites that began prior to April 2020 and were expanded after April 2020 and the local incumbent agreed to provide a greater discount in their bulk charges to reflect regulatory changes to the income offset. The respondent considers the simplest approach would be to not apply income offset discounts to the additional properties connected after April 2020.

[1] As set out in our July 2019 NAV policy document, the 'large user' criterion applies where a customer(s) uses (or is likely to use) at least 50 megalitres of water a year (if the area of the relevant appointee is wholly or mainly in England) or 250 megalitres of water a year (if the area of the relevant appointee is wholly or mainly in Wales) and wants to change its supplier.

Our assessment and decisions

For **new sites**, the wholesale minus approach should apply to all sites. This is because existing large user tariffs are unlikely to reflect the costs borne by new appointees and hence may encourage inefficient entry. We also do not consider it appropriate for incumbents to offer new appointees the lower of bulk charges based on a wholesale minus approach, or large user tariffs, primarily due their lack of cost reflectivity and the resulting bill impact this would have on an incumbent's wider customers.

However, we note that it may be appropriate for an incumbent to offer large user tariffs to prospective new appointees seeking to serve sites under the 'large user' criterion. This is because we would expect an incumbent to take the wholesale large user tariff as the relevant starting point and only deduct avoided wholesale costs (which for some sites appointed under the large criterion may be very small).

Given their different nature, we do not consider this approach represents undue preference between large users of water and new appointees.

For **existing sites**, engagement and/or a transition period may be needed to move to charges based on a wholesale minus approach, particularly if bulk charges were to rise as a result.

While we acknowledge that changing the tariffs for existing sites may affect the financial viability of individual sites currently served by new appointees, we note that once appointed to serve a site, a new appointee is required to be financeable at a company level rather than on a site-specific basis.

In terms of the approach for existing sites where the incumbent provides discounts to reflect the pre-2020 income offset and the site is expanded post-2020, we agree that it may be appropriate to provide split-tariffs for the site provided both are calculated on a wholesale minus basis.

3.2 Avoided cost estimation

3.2.1 Cost estimation approaches

What we said in our consultation

We said we were minded to prefer more cost-reflective 'bottom-up' approaches to estimate avoided costs, which use specific estimates of the typical costs incurred for different on-site activities, in contrast to less accurate 'top-down' approaches that use company-level data to derive unit costs for last-mile infrastructure.

We noted that an alternative approach would be to apply a 'middle-down' approach that would use more granular company-level data allocated to on-site activities.

Respondents' views

We received mixed views from respondents. Six respondents support the use of bottom-up approaches due to their cost reflectivity and greater accuracy, with CCW noting such approaches would minimise the level of cross-subsidy from wider customers to new appointees.

Seven respondents prefer top-down approaches arguing they are less subjective and less burdensome to administer. Some suggest such approaches may support greater market entry due to higher deductions or by enabling prospective new appointees to calculate indicative charges.

Eight respondents prefer or suggest a middle-down approach would be a good compromise, but some note the time that would be required to implement more granular reporting in the annual performance reports.

Three respondents suggest new appointees' small company returns (i.e. new appointee financial information) could be published to help incumbents quantify relevant on-site costs.

Two new appointees, Icosa Water and Independent Water Networks, suggest a common methodology is developed and applied across incumbents.

Some respondents argue the guidance should not prescribe an approach.

Our assessment and decisions

We continue to prefer the use of **bottom-up approaches** because they are more likely to result in cost-reflective bulk charges. Such approaches can make use of regional averages of different activities for simplicity and transparency, and do not necessarily need to be calculated on a site-specific basis.

In contrast, top-down approaches using company-level annual reporting data may result in highly inaccurate estimates of avoided costs. They may overstate or understate them (for example due to the inclusion of wider network costs or the presence of legacy discounts in the regulatory capital value) leading to potentially substantial inefficient entry by new appointees and negative impacts on wider customers and the effective development of the new appointments and variations market.

We recognise that adopting bottom-up approaches or developing an industry-wide middle-down approach may take time and require further engagement with industry. For this reason, while we expect incumbents to strongly consider the use of more cost-reflective bottom-up approaches when they next revise their charges, we acknowledge this may not be realised until future charging years.

We expect this to be considered further by our proposed working group, as outlined in section 4. Incumbents that continue to use top-down approaches should consider the use of cost allocation methods that ensure only relevant on-site costs are included in their estimates.

In terms of using **small companies' returns** to estimate costs, in principle the wholesale minus approach should be based on estimates of *incumbents'* avoided costs – using a new appointee's actual costs is unlikely to be a good proxy and may not facilitate efficient entry, for example when a prospective new appointee is more efficient than the incumbent. We are separately considering future regulatory reporting requirements and disclosure for new appointees.

3.2.2 Treatment of indirect costs

What we said in our consultation

We noted that we did not specify the treatment of indirect costs in our 2018 guidance and proposed that incumbents take account of relevant common costs when estimating their avoided costs.

Respondents' views

Twenty-one respondents agree with our proposal. Some respondents say that the use of top-down approaches to estimate indirect costs is more practical and transparent than bottom-up approaches.

Three respondents suggest more detailed guidance may be required to reduce variations in approach between incumbents. However, Thames Water says the guidance should not prescribe a method.

Portsmouth Water asks for clarity on the definition of common costs and Icosa Water asks whether avoided retail costs have been reviewed by CEPA and queries the range in retail margins it has observed.

Our assessment and decision

We continue to consider that indirect costs that are avoided by incumbents due to the entry of a new appointee should be included in the avoided cost element of the wholesale minus approach. We will clarify this in our revised guidance.

We recognise more detailed guidance may be required, but do not consider this should be specified in our guidance at this stage.

Indirect costs are those costs that cannot be directly attributed to the provision of a single product or service. 'Common costs' are a subset of indirect costs. Unlike 'joint costs', which are fixed, common costs usually vary by the quantity of a product or service. We consider incumbents should allocate a portion of common costs when estimating their avoided costs.

CEPA did not review retail costs because retail costs (for example billing services and reading the meters of end customers) are not recovered by wholesale charges. Where new appointees set their charges for end customers to match those of the relevant incumbent, they receive a retail margin that is equal to the efficient retail cost allowance we made for incumbents in the 2019 price review (PR19), which is why there is some variation between incumbents' areas.

3.2.3 Capital maintenance expenditure

What we said in our consultation

We noted that as for the estimation of other on-site costs, capital maintenance expenditure could be estimated using top-down, middle-down or bottom-up approaches. We said that consistent with our preference for estimating costs, incumbents should use bottom-up approaches when estimating their avoided capital maintenance costs.

In addition, we noted that because costs are likely to vary over time, incumbents should consider how best to estimate this, including the use of an average annuity.

We also noted that under new asset adoption arrangements where self-lay providers and developers are responsible for maintenance for one year after adoption, incumbents would be unlikely to avoid capital maintenance costs during this period.

Respondents' views

Eight respondents agree that bottom-up approaches should be used to estimate capital maintenance costs. One of these respondents, Thames Water, comments that bottom-up approaches are particularly appropriate to these costs because it says the lists of relevant assets required on the sites usually operated by new appointees is finite and does not significantly vary between incumbents. It also notes that publicly available costing information can be used, such as new connections prices published by incumbents and self-lay providers.

Five respondents prefer middle-down or top-down approaches instead, arguing they would be less complex, support more transparent and consistent bulk charges, or that it should be at the discretion of each incumbent. Bristol Water also suggests that the depreciation element of the wholesale minus approach effectively makes an allowance for capital maintenance.

Wessex Water comments that the nature of assets operated by new appointees will affect how they are treated. Infrastructure assets should be funded by the avoided on-site cost element, because infrastructure renewals are generally reported as operating expenditure, whereas non-infrastructure assets should in its view mimic the funding of capital maintenance in the wider regulatory framework. For these types of assets, the stakeholder proposes applying standard regulatory capital value (RCV) run-off rates to the relevant asset value in order to derive an annual maintenance charge.

In terms of the time profile of costs for individual sites, nine respondents say they agree with the use of average annuity, and South West Water agrees incumbents should consider how to reflect this in their estimates.

In terms of the impact of new asset adoption arrangements, CCW and Northumbrian Water agree with our interpretation that incumbents are unlikely to avoid costs in the first year of a new site while Waterscan disagrees, commenting there are likely to be costs incurred for sites with on-site treatment assets.

Anglian Water considers that the use of annuity would suggest a need to change the period over which the annuity is calculated rather than the removal of the avoided cost element in the first year of a new development.

Our assessment and decision

On the approach to cost estimation, as set out in in section 3.2.1, we continue to prefer the use of bottom-up approaches. As Thames Water observes, a range of information can be used to ensure avoided cost estimates are accurate. We note that estimates do not necessarily need to be site-specific but incumbents should aim to accurately reflect all relevant on-site costs, including through the use of appropriate cost modelling drivers to avoid excessive averaging.

We broadly agree that the maintenance of infrastructure assets should normally be included in the avoided cost element and that it may be appropriate for the maintenance of non-infrastructure assets (such as on-site treatment works) to be accounted for in other ways, including through the use of RCV run-off rates to estimate an annual maintenance charge.

On the time profile of costs, incumbents should consider how best to estimate this, including through the use of an average annuity. We acknowledge that adjusting the annual annuity may be an appropriate way to reflect the impact of new asset adoption arrangements on avoided costs, although we note this may disadvantage self-lay providers in cashflow terms. As such, it is for incumbents to consider how best to support a level playing field between new appointees and self-lay providers, including in relation to the impact of new asset adoption arrangements.

3.3 Rate of return element

3.3.1 Relevance of the rate of return element

What we said in our consultation

We noted that the rate of return element as set out in our 2018 guidance would no longer be relevant for English incumbents due to changes to treatment of the income offset, but that it remains relevant for Welsh incumbents where the income offset would otherwise apply to on-site assets.

Given this, we asked whether our guidance should be less prescriptive in this area.

Respondents' views

Ten respondents explicitly agree that the rate of return element is unlikely to remain relevant for English incumbents and 11 respondents agree that it is likely to remain relevant for Welsh incumbents, at least until new connection charging rules are introduced for Welsh water companies which may change arrangements.

Five respondents prefer the guidance to remain prescriptive, with some requesting that it is updated, arguing doing so would provide greater clarity and consistency for Welsh incumbents and those English incumbents where it may be relevant for some sites. However, Severn Trent Water considers that because alternative approaches could be used, the guidance should be less prescriptive in this area.

Independent Water Networks argues some incumbents have not previously included a rate of return element in their bulk charges and asks us to take corrective action. Icosa Water states it has struggled to receive any discounts under interim arrangements between 2018 and 2020 when incumbents were encouraged by us to offer a discount to new appointees that was equivalent to the income offset available to other developer services customers.

Our assessment and decision

We consider that our revised guidance should be less prescriptive in this area, particularly due to its reduced relevance for most new sites. We also acknowledge that alternative approaches could be used, as suggested by Severn Trent Water, and that key inputs and assumptions may change in future.

Welsh incumbents (and English incumbents, where relevant) can reflect on our 2018 guidance, and subsequent price review determinations, when considering how to adjust their wholesale allowed return on capital for the purposes of setting bulk charges for new appointees.

Whether incumbents have offered discounts equivalent to the income offset prior to 2020 is out of scope of this consultation. However we note that we set out a clear expectation that this would be offered to new appointees in our November 2017 decision on new connection charging rules and our 2018 guidance.

3.3.2 An additional allowance

What we said in our consultation

We noted CEPA's consideration of an additional allowance to ensure a new appointee that is equally efficient is able to earn a profit margin, and to reflect the wholesale operating risks to which new appointees are exposed.

In our consultation, we said that, in principle, any additional allowance should reflect the operational risk experienced by new appointees to operate on-site assets which the incumbent has avoided.

Respondents' views

Five respondents consider an additional allowance should reflect the operational risk experienced by new appointees. Anglian Water comments that an additional allowance would provide new appointees with an allowance that is not available to incumbents under the regulatory framework, but acknowledges providing one is appropriate to support new markets.

Southern Water comments that operational risk may already be captured in the avoided costs list provided by CEPA and more guidance may be needed to avoid double counting of these costs.

In terms of approaches to calculating an additional allowance, five respondents prefer the use of an operating margin approach, arguing it would be simpler, more transparent and consistent with regulatory approaches in other markets (such as the business retail market). They suggest it should either be applied to operating costs, the cost of sales, or turnover, and that it could either be based on the adjusted allowed return set out in our 2018 guidance or a 2.5% margin (equivalent to the margin set when the business retail market opened in 2017).

Four respondents comment that the use of an adjusted discount rate in the average annuity for avoided asset replacement costs (as mentioned in section 3.2.3 of this document) in effect provides new appointees with an additional allowed return that reflects operational risks, over and above the return available to incumbents, and is consistent with the wider wholesale minus approach to bulk charges.

Our assessment and decision

We continue to consider that any additional allowance should reflect the operational risk experienced by new appointees which an incumbent has avoided. Incumbents should ensure any additional allowance it is not double counted, such as in the avoided costs element.

Given the lack of upfront investment by English incumbents, we acknowledge that the use of a discounted cashflow approach as proposed by some respondents, where an adjusted return is used as the discount rate for an average annuity, may be an appropriate way to reflect this.

3.4 Environmental impacts

What we said in our consultation

We noted the importance of the environment in our charging framework and how the way incumbents set their charges can deliver environmental improvements.

We noted that how incumbents structure their bulk charges may create incentives on new appointees to increase their water consumption, and that encouraging new appointees to improve their water efficiency is likely to benefit incumbents and their customers through improved supply-demand balances, resilience and reduced upstream costs. Similarly encouraging on-site sustainable drainage should also increase the resilience of incumbents' wastewater assets, thereby reducing the risk of pollution incidents and flooding.

We asked whether our guidance should state that bulk charges should not financially penalise new appointees for promoting greater water efficiency.

We also asked whether new appointees should receive discounted charges if they deliver sustained lower water consumption (and similar improve outcomes for wastewater) based on the avoided costs or mitigated environmental impacts.

Respondents' views

On the principle

Most respondents agree with the principle of encouraging new appointees to promote greater water efficiency, but some raise concerns with how to practically and fairly implement this through bulk charges.

Southern Water and Yorkshire Water say there is limited evidence of strong incentives on new appointees to increase consumption due to the structure of bulk charges, partly because new appointees are required under legislation to promote water efficiency.

Southern Water and Thames Water consider that any structure of bulk charges will, to a degree, incentivise new appointees to increase consumption. However, five respondents note that incumbents can already provide discounted charges that incentivise new appointees to promote water efficiency, for example by setting bulk charges:

- that are wholly or substantially based on the volume supplied (with no fixed element or standing charge) which would enable new appointees to set a unit rate for their end customers (with a standing charge) that is lower than the rate charged by the incumbent;
- where the avoided costs element is calculated on a per property rather than a volumetric basis, or through the use of assumed consumption levels per property, which could be based on regional averages;
- that do not provide increased discounts for higher volumes of water usage (i.e. there is a uniform volumetric rate, though the avoided costs element can increase where this reflects higher costs associated with larger sites, for example because the site would require other network assets); and
- that reflect whether surface water drainage charges would be incurred if there are sustainable drainage systems on the site.

Four respondents note the existence of other ways of promoting water efficiency beyond the bulk charges framework, such as:

- the provision of discounted infrastructure charges for new properties with water efficient fittings or sustainable drainage systems, which some incumbents currently make available to new appointees as well as other developers; and
- the water resources planning process or water bidding market, whereby new appointees could 'bid' to improve incumbents' local supply-demand balances.

South East Water comments that the relatively small scale of new appointee sites is unlikely to affect incumbents' supply-demand balances and so lead to avoided upstream costs, and Wessex Water raises practical issues given infrastructure charges, which are paid by new appointees on the connection of new properties, are required to reflect network reinforcement costs.

On changing the guidance

Five respondents say they agree that the guidance should be revised to state that bulk charges should not financially penalise new appointees for promoting greater water efficiency.

Five respondents disagree with changing the guidance, arguing the issue we raise is a market or regulatory design challenge for Ofwat and not for incumbents to manage in their bulk charges, that further design and definition work is required, or that such a broad statement would be unnecessary and unhelpful, particularly if an incumbent is unable to ascertain activities by new appointees to promote water efficiency.

On drafting the guidance, so as to not unnecessarily or indirectly restrict potential charging structures, three respondents comment that rather than stating that bulk charges should not **financially penalise** new appointees, the guidance should state that bulk charges should not **disincentivise** (or **explicitly or intentionally** disincentivise) new appointees from promoting greater water efficiency.

On providing discounted charges

Six respondents say they agree with the principle of providing discounted charges to new appointees if they deliver sustained lower per capita consumption (and similarly improved wastewater outcomes). A further two respondents, Northumbrian Water and Thames Water, agree with providing discounts for surface water drainage charges that reflect reduced demand on incumbents' sewer networks.

However, 12 respondents disagree with the prospect of further discounts, arguing they are not required or that it would not be appropriate to apply these through bulk charges for new appointees, with the following key points:

- new appointees have legal duties to promote water efficiency;
- existing discounts on infrastructure charges available to new appointees are sufficient and there is a risk of double counting if further discounts were applied through bulk charges;
- alternative approaches may address the issue without adding significant complexity, such as the use of regionally averaged assumed per property consumption when estimating bulk charges, or the use of market mechanisms to fund the upfront costs of grey water reuse;
- an equivalent discount is not available in other markets where they may have a bigger impact, such as the business retail market;
- as a measure, per capita consumption would not an appropriate means of incentivising reduced water usage due to issues with its calculation;
- it would be inappropriate for incumbents to manage what would essentially be a regulatory mechanism for new appointees;
- long-term savings from sustained lower per capita consumption will be reflected in the wholesale revenue allowances made in future price reviews, at which point this will automatically be reflected in bulk charges for new appointees;
- it would be challenging to implement and would add significant complexity and be burdensome to regularly estimate per capita consumption on each site; and
- such discounts should not be funded by incumbents' wider customers.

Three respondents suggest that this issue could be addressed by setting specific price controls for new appointees on the charges paid by end customers, while Severn Trent Water considers that revenue caps as applied to incumbents with corresponding incentives would be disproportionate for new appointees.

Icosa Water argues it is more important that incumbents recognise that their sites typically have lower consumption due to the prevalence of more water efficient properties compared with incumbents' portfolios.

Thames Water also comments that highways and surface water drainage services are not mentioned in our May 2018 bulk charges guidance and that it may be useful to include information on how new appointees should be charged for these services, for instance from our 2015 statement of policy on new appointments and variations.

Our assessment and decisions

On the principle

We are supportive of incumbents considering the right balance of fixed and volumetric elements in their bulk charges for new appointees. We are concerned by charges that, by not being cost reflective, financially penalise new appointees for delivering greater water efficiency.

This might be addressed through greater reliance on volumetric charges. Equivalently, as some respondents note, it may be appropriate for the avoided cost element to be estimated on a per property basis in order to set the right environmental incentives for new appointees – selecting suitable cost drivers is covered in CEPA's report and incumbents should reflect on this, as well as examples of good practice raised by respondents to this consultation, when setting their bulk charges.

Changes to our guidance

In terms of changes to our guidance, based on stakeholder feedback we are consulting on revised wording to encourage incumbents to consider the impact of how they structure their bulk charges on environmental outcomes (see section 4.2).

On the scope of avoidable costs considered

We acknowledge the challenges and concerns with implementing further discounts or bespoke regulatory mechanisms into bulk charges for new appointees relating to per capita consumption, particularly where it is not clear that the lower demand will be sustained or if the avoided cost has already been accounted for.

However, based on CEPA's report and the feedback provided by respondents to this consultation, we consider there is merit in incumbents considering how best to reflect environmental benefits from avoided upstream costs due to reduced water usage.

On surface water drainage and highway charges, we will include a reference in our revised guidance. We also note many incumbents already reflect the impact of reduced demand on their networks in their bulk charges, for example by reducing charges for surface water drainage where sustainable drainage systems are in place, and we expect all incumbents to consider this issue.

4. Implementation

In the previous section we have considered and assessed the methodological issues raised in our consultation or by respondents.

In this section we set out our approach to ensuring the new appointments and variations market is well-functioning and delivers improved outcomes for customers, the environment and wider society, and how we intend to implement our conclusions.

4.1 Our approach

Our work over the last year to review incumbents' support for effective markets, to which CEPA's report contributed, showed that new appointees are now much better able to calculate whether they can profitably compete for developer services because incumbents are publishing new connection charges and bulk supply and discharge charges for new appointees. The greater transparency improved during our review, and we expect further transparency to come.

We were concerned that incumbents are not ensuring that their charges are cost reflective. This can act as a barrier to competition in some markets in some incumbent areas.

At the same time that we published our main report we wrote an open letter to each incumbent setting out areas where they performed relatively well and areas that require attention. Notwithstanding this, we consider that there are improvements and refinements to be made by all incumbents to improve **cost reflectivity** and **transparency** of bulk charges for new appointees, and that there would be benefits to new appointees of greater consistency of approach.

We will revise our 2018 guidance to facilitate this. The changes will refine and evolve our approach to any disputes or determinations that we may consider in respect of bulk charges between new appointees and incumbents. As such, while it may not be proportionate in some cases for incumbents to re-consult on adapting their approach to setting bulk charges, they should reflect on how they may improve the cost-reflectivity and transparency of their charges.

This work fits within the context of our wider strategy, in particular by enabling the development of markets where they can bring the biggest benefits to customers, facilitating greater innovation and better value for money for customers.

To do this, we are implementing a three-step response as follows:

- **revising our guidance** – to help further improve incumbents' performance on charging;

- **initiating a working group** on bulk charges for new appointees – to facilitate incumbents and new appointees to improve practice and consistency in approaches to bulk charges through increased collaboration; and
- **meeting long-term challenges** – to meet future customers' needs and for incumbents and new appointees to serve a wider public purpose, delivering more for their customers, the environment and wider society.

4.2 Implementing our conclusions

In this section we set out how we propose to take forward this work in more detail. We will principally do this by facilitating immediate action, through publishing the CEPA report, our consultation conclusions and revisions to our guidance that support tangible changes to bulk charges in 2021-22, as well as promoting continuous improvement through a working group to support enduring change.

Almost all respondents agree with our proposal not to develop charging rules at this stage in favour of revising our guidance and initiating a working group. We will continue to monitor incumbents' practices and if we have concerns about the effectiveness of our guidance we may reconsider whether developing charging rules would be appropriate.

4.2.1 Revising our guidance

What we said in our consultation

We said we may decide to amend our guidance on bulk charges and that if we did, we would consult on revised guidance before finalising any changes to enable incumbents to revise their bulk charges for new appointees in early 2021.

Our draft guidance

Alongside this document, we are consulting on revising our guidance and we welcome comments from stakeholders.

In summary, we are proposing to apply the following revisions to our 2018 guidance:

- an expectation that incumbents use **menu-based approaches** so that charges reflect the actual mix of properties in the relevant starting point, making bulk charges for new appointees more cost reflective and accessible to new appointees;
- a clarification that charges for all sites should be based on the wholesale minus approach rather than **large user tariffs**, while recognising transitional arrangements may be needed for existing sites;

- a preference for **bottom-up cost estimation approaches** when incumbents calculate their avoided costs to promote the development of more cost-reflective charges;
- a clarification that **indirect costs** that are avoided by incumbents due to the entry of a new appointee should be included in the estimation of avoided costs;
- that incumbents should carefully consider which avoided costs are appropriate for a site, using industry best practice where appropriate – we consider CEPA's **list of avoided costs** that are common to most sites served by new appointees[2] to be a useful starting point, and this may evolve over time;
- a revised approach to the **rate of return element**, reducing the level of prescription on providing an appropriate allowance for new appointees, which may include the use of an adjusted rate of return when estimating average annuities;
- a new principle which sets out that we expect incumbents to consider the impact of how they structure their bulk charges on **environmental outcomes**; and
- additional detail on the approach to avoided surface water drainage and highway charges.

Our expectations

We expect incumbents to consider our draft guidance and CEPA's report when developing their bulk charges for 2021-22.

4.2.2 Initiating a working group

What we said in our consultation

In our consultation, we noted CEPA's discussion of an industry-led process, with our input, to consider the most effective way to collect relevant information for setting bulk charges and to consistently allocate costs to last-mile infrastructure.

We noted the success of the NAV market behaviour improvements project, co-ordinated by Water UK and chaired by a representative from South East Water with substantial inputs from other incumbents, and said we considered it provided a useful model for other industry-led initiatives, including on bulk charges for new appointees.

[2] See appendix B of CEPA's report.

Respondents' views

Almost all respondents are supportive of setting up an industry-led working group to complement and further consider the CEPA report and other practical issues relating to bulk charges for new appointees.

A few respondents note the need for careful facilitation to manage any competition issues, such as involvement by Ofwat.

Some respondents request that wider stakeholders are included in any such group.

Our proposed next steps

We intend to progress with initiating a working group to promote more consistent approaches across incumbents and better sharing of best practice, for example with respect to bottom up cost methodologies and treatment of environmental costs. This can take the form of virtual meetings as well as email correspondence as appropriate to meet its objectives.

We also want to use the group to consider some of the issues raised by the CEPA report, our consultation, and other issues as they may arise. We expect to set the strategic direction of this group and to set out the objectives, review cycle and our expectations of how collaboration and partnership working should take place.

Following the publication of this document, we intend to engage with relevant stakeholders, including those incumbents that express a particular interest in being involved, in the coming weeks. We also consider it appropriate to include other stakeholders, such as new appointees, in these discussions. We welcome interested stakeholders to contact us at NAVpolicy@ofwat.gov.uk.

4.2.3 Meeting long-term challenges

We expect the working group to help inform any future revisions we may make to the guidance and to support the sharing of best practice and the development of more consistent, cost-reflective charges ahead of the charging year commencing in April 2022.

In the longer term, we would expect the group to keep under review any common methodologies and approaches that are developed, and to consider other strategic issues which may be of relevance, such as promoting transparency, environmental incentives for new appointees, and improved monitoring, reporting and performance.

We will continue to consider whether charging rules are required, having regard to developments in the market, the views of stakeholders and the strategic priorities of the UK and Welsh Governments.

5. Next steps

Stakeholders should comment on the draft of our revised guidance by 8 December 2020. Informed by the feedback we receive, we expect to finalise the guidance in January 2021.

Incumbent companies are to finalise their bulk charges for the 2021-22 charging year in early 2021, and we expect them to consider our conclusions and the draft version of our guidance when developing those charges. In many respects incumbents should be able to set bulk charges that reflect our conclusions and this draft guidance without significant rework or delay.

We will shortly engage with relevant stakeholders to initiate a working group, in anticipation of further changes and improvements to incumbents' bulk charges for new appointees in 2022-23 and beyond.

Roadmap – Bulk charges for new appointees

	2020-21 charging year	2021-22 charging year	2022-23 and beyond
Ofwat	Publishes CEPA's report on bulk charges for new appointees. Consults on bulk charges, and then on guidance to improve **transparency** and **cost-reflectivity** of bulk charges. Initiates a working group on bulk charges.	Sets **strategic direction** and **confirms objectives** for the working group, promoting **collaborative working** between incumbents and new appointees.	Addresses issues including whether the needs of **future customers** are **the environment** are being served by current approaches; whether to set **bulk supply charging rules**.
Incumbents	**Review** CEPA's report, our conclusions and the revised guidance. Plan for implementing the guidance, including making **changes for 2021-22** and addressing **transitional issues**. **Establish** a working group.	Finalise **working group** scope, governance and short-term objectives. Identify best practice and develop common approach to **methodological** problems, for implementing in 2022-23. **Engage** with new appointees on addressing **transitional arrangements**.	Alongside wider stakeholders, take ownership of **strategic initiatives** and **future work programmes** of the working group.
New appointees	**Engage** with Ofwat and industry consultations	Lead work to **highlight areas of refinement** and **appraise improvements** in incumbents' approaches to bulk charges.	Lead some initiatives to **refine potential common methodological** approaches. Help to **evaluate the effectiveness** of the working group.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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