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Regulation

Name: Nicola Cocks
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8 December 2020

Dear Jeevan,

NAV bulk charges revised guidance consultation response – December 2020

Thank you for the opportunity to provide feedback on the proposed revised guidance for setting NAV bulk charges. Our detailed feedback can be found in Appendix 1.

We appreciate and support the flexibility that Ofwat are proposing to retain in the guidance regarding the methods that companies can use when addressing the components of the wholesale-minus approach. We are also encouraged by the acknowledgement that for some elements of the NAV bulk charges setting process, some companies will need to work towards the expectations set out in the revised guidance over the next couple of years.

As mentioned previously, forming an industry-led working group for NAV bulk charges is something that we see as a positive step that we would be happy to be involved with. We do however feel that the remit of such a group should be focussed on the methodologies used to set charges. We do not believe it would be appropriate for such a group to discuss the prices that incumbents plan to charge.

We also feel that a working group would be most effective if the published guidance was not too restrictive. If a specific approach to an element of the wholesale-minus methodology is essentially set out in the guidance as being the only option incumbents should use, then the role of the working group is significantly diminished. For the working group to facilitate meaningful discussion, incumbents need to have freedom within the guidance to choose methods most relevant to them to set charges that are as cost reflective as possible. This is particularly relevant to topics 1 and 3 in Appendix 1.

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 on-going development of NAV bulk charges and competitive markets throughout AMP7.

Yours sincerely,

[redacted]

Nicola Cocks
Regulation Director

Appendix 1

This appendix contains the Thames Water response to the topics raised in the consultation.

1. **Menu-based relevant starting point for wholesale-minus approach**

Ofwat have maintained the position expressed in the original consultation in that their preference is for incumbents to use a menu-based weighted average when determining the relevant starting point.

We understand and appreciate the rationale behind this preference as it sets out to achieve site-specific cost-reflectivity, however given the typical composition of NAV sites that we serve, a menu-based approach would be highly likely to give the same answer as our current "wholly household" approach to setting the relevant starting point. It would however have a number of practical downsides, namely:

- additional and on-going administrative burden for the NAV in having to formally submit plans each year that set out the customer composition of each site;
- additional administrative burden for the incumbent in calculating and applying through their billing systems the bespoke NAV bulk charges applicable to each site; and
- the inability of published tariff documents to definitively set out what the charges will be for a specific NAV site.

We appreciate that the final point raised above could be overcome via the publication of a tariff calculator, but this then adds to the administrative burden for both the NAV and the incumbent as set out in the first two bullet points above (also elaborated on further below).

As previously mentioned, 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 20,000m^3 (being the threshold above which the non-household metered unit rate diverges from the household metered unit rate). Typically, non-household properties on our NAV sites will be small retail units and schools.

There are currently 28 NAV sites in the Thames Water service area. We expect the number of sites to continue to grow, with a central forecast that this will double over the period to 2025.

Under the proposed approach, each incumbent and NAV will need to bear the aforementioned administrative burden of keeping up-to-date information relating to each of the individual sites in order to separately determine the NAV bulk charges to be applied. It should be noted that:

- this is not a one-off calculation as most NAV sites have build-out profiles that extend over multiple years (typically up to 5 years);

- the connection of individual premises would need to be kept up to date from year-to-year (and potentially even within each year) to accurately reflect the bespoke relevant starting point; and
- this would require data relating to the number of household connections, the number of non-household connections and the volume used by those non-household connections to be refreshed at least annually.

The above points raise the question of how often this data should be updated and, if this is not a continuous update, whether annual tariffs should be based on backward-looking data or forward-looking forecast data. In addition, a requirement for data validation would also need to be considered so that the data provided by the NAV can be verified by the incumbent.

The incumbent would then need to set up each separate bespoke tariff within its billing systems, which may involve creating a separate tariff code for each NAV site. For comparison purposes, most incumbents will have just one metered tariff in use for household customers, but there is the potential for us to require more than 50 by the end of 2025 under the proposed approach.

Given the typical mix of use at NAV sites particularly in our service area, the proposed approach seems disproportionately burdensome for both the incumbent and the NAV. It could lead to uncertainty about the tariffs that will apply and a subsequent increase in billing disputes. At a time when there are calls, more generally, for tariff simplification to enable entrants to compete effectively, we feel that the proposed approach should not be prescribed in the revised guidance. We do however acknowledge that it may be more relevant where a NAV site has been appointed under the large user criterion.

As such, we maintain and reiterate our position, as set out in section 6.1 of CEPA's report and inherently supported by United Utilities[1], that it would be appropriate for the guidance to continue to allow the flexibility of using the various approaches currently adopted by incumbents.

As per the conclusions drawn following the initial consultation, we appreciate the allowances that Ofwat are making in anticipating that existing incumbent practices will evolve to a menu-based approach over the next two years. If the final guidance reflects the draft guidance in this respect, we feel that it would be proportionate and appropriate for us to consider offering a bespoke approach to setting NAV bulk charges only when a site serves intermediate (or larger) water users and/or large wastewater users. For our published NAV bulk charges, we would retain the status quo of the relevant starting point being based wholly on our wholesale rates for household customers.

Keeping the relevance of a menu-based approach under review, in the context of the full range of NAV portfolios held by incumbents, is something that we feel the industry and Ofwat should ensure happens on an on-going basis in future years.

[1] "Bulk charges for new appointees - our conclusions", Ofwat, November 2020, section 3.1.1, page 8

2. Large user tariffs for NAV sites

We note with interest the scenario in which incumbents' large user non-household wholesale charges may be more appropriate to use than the NAV tariffs derived according to a wholesale-minus approach due to the appointment being made under the large user criterion.

While we do not currently have any NAV sites appointed on this basis, it is something that we will keep under consideration should the need present itself.

3. Approach to calculation of avoided costs

Ofwat have maintained the view expressed in the original consultation that their preference is for incumbents to use a bottom-up approach to estimating avoided on-site costs.

Particularly in light of the varied responses received to the initial consultation in which there was almost an even spread across respondents supporting the top-down, middle-down and bottom-up approaches[2], we stand all the more firmly in our belief that the guidance should not rule out any of the currently used methods to calculating avoided on-site costs.

The view shared by two new appointees that a common methodology should be developed and applied by all incumbents could be fulfilled more readily by using the top-down or middle-down approaches. This was also noted in CEPA's report[3]. While the trade-off in cost-reflectivity may be too much of a compromise for the top-down approach to become the industry standard, we feel that this at least reinforces the view that none of the currently used methods should be ruled out in the guidance. We believe that this gives further merit to the suggestion from a number of respondents that the guidance should avoid prescribing an approach.

If the final guidance reflects the draft guidance on this topic then, as per the conclusions drawn following the initial consultation, we appreciate the allowances that Ofwat are making in their acknowledgement that the use of bottom-up costing may not be realised in incumbents' practices until future charging years. Should the final guidance specify a preference for a bottom-up approach to costing, we would agree that, so as to form a common base of on-site costs that incumbents will avoid, the list used by CEPA is a valid starting point.

[2] Six respondents supported the bottom-up approach, eight the middle-down approach and seven the top-down approach as per section 3.2.1 on page 12 of "Bulk charges for new appointees - our conclusions" published by Ofwat in November 2020.

[3] "Bulk Charges for New Appointments and Variations (NAVs) Regime in the Water Industry in England and Wales", CEPA, April 2020, section 6.2, page 55

4. Additional allowance on the rate of return

Ofwat's conclusions from the initial consultation set out some of the ways in which a premium rate of return may be reflected in the calculation of NAV bulk charges to allow for the additional operational risk and reduced regulatory protection that a NAV experiences over that of an incumbent.

We welcome the acknowledgment from Ofwat that such an adjustment can be legitimately reflected by using a discount rate that is higher than the incumbent WACC when calculating asset maintenance annuities.

We also welcome the fact that, while the guidance relating to the rate of return element has been made less prescriptive, Ofwat state that, where relevant, companies can refer to the original May 2018 guidance and subsequent price controls to inform the inclusion of an additional allowance on the rate of return element.

5. Environmental incentives

The original consultation suggested that incumbents could provide further discounts to NAV bulk charges where a sustained reduction in water usage, by reference to per capita consumption ("PCC"), could be evidenced. We are pleased to hear that a significant number of other respondents felt, as we did, that NAV bulk charges are not the place for such reductions to be applied.

While we maintain our position that reference to PCC reductions and subsequent additional discounts should not feature in the NAV bulk charges guidance, we note that its inclusion in the proposed revised guidance is worded such that it is not a mandatory requirement. Rather, it may be one of a number of options that incumbents could consider in order to meet the environmental impact requirement that bulk charges do not financially penalise new appointees for promoting greater water efficiency.

We feel that this is a topic that the working group could usefully consider to ensure that NAV bulk charging structures and the associated guidance only include environmental incentives that are appropriate for incumbents to offer.

6. Surface water and Highway drainage charging

We are pleased to see that explicit reference is now made in the guidance to the charging principles that should be considered with regard to surface water and highway drainage services. Formalising and reiterating the statement of policy published by Ofwat in April 2015 is a welcome step that we feel clarifies an area that was missing in the original May 2018 guidance.

This was of particular interest to us as we have recently republished our 2020-21 NAV Tariff Document[4] to explicitly offer abatements for highway drainage services as well as surface water drainage services.

[4] "NAV Tariff Document 2020-21", Thames Water, November 2020