

January 2021

## **Bulk charges for new appointees – conclusions on revising our guidance**

## About this document

We consulted on revising our guidance on the **bulk supply or discharge charges paid by new appointees** (also known as NAVs or small companies) to larger water companies (**incumbents**) in November 2020. This followed our [initial July 2020 consultation](#) on our approach to regulating bulk charges for new appointees.

This document summarises the views of respondents to our [November 2020 consultation](#) and sets out our conclusions and next steps. We also publish our final guidance ([‘Bulk charges for new appointees – guidance on our approach and expectations’](#)) which sets out our approach to determining bulk charges in the case that incumbents and new appointees are unable to agree the price of a bulk supply or discharge agreement; and the behaviours we expect from incumbents when setting their bulk charges for new appointees.

To enable stakeholders to understand how our draft guidance has changed, we include an annotated version as an appendix to this document (see appendix 1).

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**).

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# 1. Introduction

## 1.1 Background

When appointed to serve a site under the [new appointments and variations framework](#), in most cases new appointees need to agree a bulk supply or discharge agreement with the local incumbent company to ensure the supply of water and wastewater services to the site.

Bulk supply or discharge agreements can be between incumbents or between incumbents and new appointees. This document refers to the charges paid by new appointees to incumbents for the bulk supply of water or the bulk discharge of wastewater.

Where parties are unable to agree a bulk supply or discharge agreement, either party can raise a dispute under sections 40, 40A, 110A and 110B of the Water Industry Act 1991. We are then able to determine the terms (including the price) of the bulk supply or discharge agreement in line with our duties and relevant provisions of the Water Industry Act 1991.

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 should also facilitate a level playing field to the benefit of customers, the environment and wider society.

### Policy developments

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 November 2020 we published [our conclusions and next steps](#) and [consulted on a draft version of our guidance](#). Our guidance sets out our approach to determining bulk charges in the case of a determination and our expected behaviours of larger water companies when setting bulk charges. Proposed revisions were informed by findings from CEPA's report and stakeholders' responses to our July 2020 consultation. Further revisions are informed by stakeholders' responses to our November 2020 consultation.

## 1.2 Responses to our November 2020 consultation

We received responses from 14 stakeholders to our consultation, which was open from 10 November 2020 to 8 December 2020. We publish these responses in full on [our website](#).

Respondents consisted of 12 incumbents and two new appointees (Independent Water Networks and Leep Water Networks).

## 1.3 Summary of responses

Overall, the majority of respondents support our proposal to revise our guidance. For this reason we have decided to finalise our guidance with the expectation that incumbents consider our final guidance when developing their bulk charges for new appointees in 2021-22 and beyond.

As well as our general wholesale minus approach, there is strong support for our proposals on the rate of return, environmental incentives and the introduction of an industry working group to consider issues further.

Most respondents agree with our proposals on the use of menu-based approaches, our approach to the use of large user tariffs and bottom-up approaches to cost estimation – as such we focus on addressing the concerns raised by some respondents in the next section. In that section we set out the key issues raised by respondents, our view and any revisions made to our final guidance as a result.

We do not consider in detail those existing issues that we previously addressed in our November 2020 conclusions. In response to some of the comments we received, we also provide clarifications where we consider it helpful to do so.

Further issues raised by stakeholders may be addressed at a later date, either in future revisions to our guidance, the new industry working group, or through charging rules if we consider our policy objectives are not being met under current arrangements.

## 2. Key issues raised

In this section we address the key policy issues raised by respondents and provide clarification where we consider it to be appropriate.

### 2.1 Policy issues

#### 2.1.1 Relevant starting point

##### Our draft guidance

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

Most respondents support our view that charges should be presented on a 'menu-based' approach so that new appointees can calculate their bulk charges based on the actual mix and quantity of properties supplied on a site.

Southern Water and Thames Water disagree with our proposed approach, suggesting that a 'wholly household' approach would likely provide a similar charge, be more practical and support the development of the market. They consider menu-based approaches would add administrative burdens.

United Utilities notes that it currently uses a single average tariff for both household and non-household properties for simplicity and asks for clarity on what is meant by a menu-based approach.

##### Our final view

We confirm that we expect bulk charges to use menu-based approaches when setting the relevant starting point. This means publishing bulk charges such that new appointees can ascertain the charges that would apply to them based on the actual mix of household and non-household properties on each of their prospective and existing sites.

We do not consider producing and operating menu-based approaches to be overly burdensome, particularly as relevant property data will now be published on an annual basis in each new appointee's small company return and we expect incumbents to have ongoing engagement with new appointees in their region. As we observed in our [review of](#)

[incumbents' support for effective markets](#), incumbents have an important role to play in supporting markets to be effective and should actively consider how to support markets, including by refining and improving their processes when interacting with new appointees. We also note that some incumbents, such as Severn Trent Water, already set successfully set bulk charges on this basis.

While we accept that it may not be practical to implement this approach in the short term for a minority of incumbents, we expect it to be implemented by 2022-23 at the latest. Until then, relevant incumbents should present their averaged approaches to demonstrate whether there is a material difference between the incumbent's wholesale charges for household and non-household properties.

## 2.1.2 Large user tariffs

### Our draft guidance

We said that the wholesale minus approach should be applied to bulk charges for all new sites, though we recognised that it may be appropriate for incumbents to offer large user tariffs for sites that are appointed under the large user criterion only.

For existing sites, we said engagement and/or a transition period may be needed.

### Respondents' views

United Utilities says that for some sites the large user tariff may lead to a lower charge for new appointees and notes that it currently offers the 'lesser of' charges developed under the wholesale minus approach and larger user tariffs but will review this in light of our final guidance for 2022-23 bulk charges.

Independent Water Networks disagrees with our proposed approach to the large user tariff, where we said that most sites served by new appointees should be charged on a wholesale minus basis and that large user tariffs are to only be relevant where there is one or more single large user of water as end customer(s) on a site. The respondent says it may raise formal determinations as a consequence when revised charges are published.

### Our final view

We remain of the view that the wholesale minus approach should be used to set bulk charges for new appointees. (In the case of a site consisting of a large user, the relevant wholesale charge is the large user tariff and, consistent with our approach, avoidable costs should be deducted.) Unlike large user tariffs, this ensures bulk charges are more cost reflective and reduces the risk of inefficient entry. While we accept this may lead to new appointees paying higher charges than if large user tariffs were available to them, the alternative is for the end

customers of incumbents to bear a greater share of upstream costs through higher bills. As such, we expect incumbents to modify their approaches, including for existing agreements, in line with the timelines set out in this document and our final guidance.

In terms of the framework for determining bulk supply or discharge agreements, under the Water Industry Act 1991 disputes may only be referred to us by incumbents or new appointees on a site-specific basis, relating to a specific proposed or existing bulk supply or discharge, and not on the basis of an incumbent's or our upfront charging publications. In addition, we have discretion on whether to make a determination where one is requested, and our power to do so requires us to be satisfied that both parties have exhausted best efforts to negotiate a bulk supply or discharge agreement. We note any determination we carry out with respect to bulk charges for new appointees will be made with reference to our guidance.

### **2.1.3 Cost estimation approaches**

#### **Our draft guidance**

We said we preferred the use of bottom-up approaches when estimating avoided costs within bulk charges. We acknowledged adopting such approaches may take time for some incumbents and that changes may not be realised until future charging years.

#### **Respondents' views**

Most respondents support our preference for incumbents to use bottom-up approaches to estimating their avoided costs. Some respondents suggested that it may take a few years for bottom-up approaches to be fully implemented and welcome our acknowledgement of this in the draft guidance.

A number of stakeholders agree that the list developed by CEPA of costs that are commonly avoided is a valid starting point.

Thames Water, Southern Water and Wessex Water say the guidance should avoid prescribing an approach, though Thames Water welcomes our acknowledgement that bottom-up estimates may not be realised until future charging years.

#### **Our final view**

We continue to prefer the use of bottom-up approaches because they are more likely to result in cost-reflective bulk charges. It will be an important focus for us to work with incumbents to refine their approaches to cost estimation and improve the consistency in how they apply them, including through our proposed working group.



As we have recognised, adopting bottom-up estimates may take time or require further engagement with industry and as such we acknowledge changes may not be fully implemented until future charging years. However, we consider incumbents have sufficient knowledge of their own businesses to avoid unnecessary delays. As a minimum we expect incumbents to have considered how they could incorporate changes to their approaches when they next revise their bulk charges.

## **2.2 Requests for clarification**

### **2.2.1 Our approach to disputes**

#### **Respondents' views**

Leep Water Networks asks for greater clarity on how disputes under the Water Industry Act 1991 may be determined and expected timescales. The respondent also suggests that we set an 'interim' decision that would apply while we carry out determinations.

#### **Our final view**

Our policy approach to bulk charges is designed to encourage and enable incumbents and new appointees to agree fair bulk charges, greatly reducing the likelihood of disputes. We recognise the importance of finalising bulk agreements in a timely manner, though the time taken to make a determination will depend on the individual circumstances of each case.

We do not have the power to impose an interim decision on disputing parties prior to our formal determinations. Nonetheless we expect both parties to use their best endeavours to reach an agreement that works for all relevant stakeholders prior to seeking a determination by us.

### **2.2.2 Highway drainage charges**

#### **Respondents' views**

Southern Water requests further clarity on the proposed approach to highway drainage charges. The respondent notes that our draft guidance states that the cost of managing highway drainage should already be accounted for in the relevant starting point which is in contrast to its current approach and may lead to increases in the bulk charges paid by new appointees.

## Our final view

In our draft guidance we noted that because wastewater companies (and ultimately the generality of customers) bear the costs of highway drainage through their sewerage bills then any costs related to this will automatically be included in the wholesale charges used in the relevant starting point when incumbents set their bulk charges. We stated any material highway drainage costs that are avoided should be deducted as an avoided cost.

While this may lead to an increase in bulk charges for some new appointees, such as where incumbents do not currently follow our proposed approach, we consider this approach ensures that new appointees' contributions are fair and consistent with our wider wholesale minus approach to bulk charges.

We note the overlap with [Ofwat NAV Policy - Frequently Asked Questions](#). For the purposes of developing bulk charges on a wholesale minus basis, we consider the approach we have set out in this conclusions document and our final guidance to be the most appropriate and takes precedence over existing guidance. We will revise other relevant documents at the next available opportunity.

### 2.2.3 Vacant properties

#### Respondents' views

United Utilities queries how vacant properties should be treated when setting bulk charges for new appointees. The respondent identifies four options, preferring a fixed charge for each connected property with an additional fixed discount for the average percentage of vacant properties for a typical site.

#### Our final view

We recognise that incumbents may need to make an allowance for the vacancy status of properties served by new appointees when structuring their bulk charges, though we do not propose to prescribe an approach in our guidance. To promote consistency across incumbents, this could be considered by the industry working group.

### 2.2.4 Customer bad debt

#### Respondents' views

Leep Water Networks suggests that the wholesale element of customer debt should be considered as an avoided cost, arguing the incumbent is able to recover charges for all services to the new appointee and is therefore not required to make a provision for debt.

Yorkshire Water suggests adding a reference to ‘debt management’ or ‘the cost of bad debt’ as example of retail costs that should not be deducted from wholesale charges under the wholesale minus approach.

### **Our final view**

We consider new appointees already have a sufficient allowance for the non-payment of bills by customers (‘customer bad debt’). When we set price controls for incumbents, we include an allowance for customer bad debt in each incumbent’s residential retail control – this includes the wholesale element of customer bad debt. This has the effect of ensuring new appointees have the same incentives as incumbents to reduce the level of customer bad debt. Because this is addressed through retail charges there is no need to make a further allowance in the bulk charges paid by new appointees provided our approach to price controls for incumbents does not change.

We agree that the cost of *managing* customers’ bad debt (as well as the bad debt itself) is a retail cost and therefore should not be deducted from the relevant starting point. This has the effect of providing an allowance for new appointees to manage the costs of customer bad debt. We clarify this in the final guidance.

## **3. Next steps**

### **3.1 Revising our guidance**

Now that we have issued our final guidance, we expect incumbents to consider how to apply the guidance when developing and publishing their bulk charges for new appointees. As we have said previously, incumbents should have been able to set their 2021–22 bulk charges without significant rework or delay based on our November 2020 conclusions and draft guidance. This should lead to noticeable improvements from 1 April 2021.

More material changes should follow in future charging years, starting from April 2022 or at an earlier date. We acknowledge that some aspects, such as the approach for existing sites and the development of new cost estimation approaches, may take up to two years to be fully implemented.

To enable stakeholders to understand how our draft guidance has changed, we include an annotated version as an appendix to this document (see appendix 1).

### **3.2 Initiating a working group**

As we proposed in our November 2020 consultation, we will shortly initiate a working group, in anticipation of further improvements to incumbents' bulk charges for new appointees in 2022–23 and beyond.

This will be an important focus for us over the next two years in facilitating continuous improvements and refinements to bulk charges and related issues. Stakeholders' responses to this proposed group and the industry roadmap we set out were encouraging and we anticipate effective co-operation between stakeholders on addressing outstanding issues and areas for improvement.

## Appendix 1: ‘Bulk charges for new appointees – guidance on our approach and expectations’

This is our guidance as of January 2021. The text in red represents amendments from the draft guidance in our November 2020 consultation. We have published our [final guidance](#) as a separate document on our website.

This document provides guidance on how we currently regulate the **bulk supply or discharge charges paid by new appointees** (also known as NAVs or small companies) to larger water companies (**incumbents**) in England and Wales.

It includes two key elements:

- our **approach to determining bulk charges** in the case that incumbents and new appointees are unable to agree the price of a bulk supply or discharge agreement; and
- our **expected behaviours of incumbents**, which sets out what behaviours we want to see from incumbents as they consider how to apply this guidance when developing and publishing their bulk charges for new appointees.

The guidance should be read in conjunction with the following guidance and documentation, as well as in the context of the relevant provisions of the Water Industry Act 1991:

- **‘Bulk charges for new appointees – conclusions on revising our guidance’** (January 2021);
- [‘Bulk charges for new appointees – our conclusions’](#) (November 2020);
- CEPA: [‘Bulk charges for new appointments and variations regime in the water industry in England and Wales’](#) (April 2020);
- [‘Negotiating bulk supplies – a framework’](#) (August 2013); and
- [‘Bulk supply pricing – a statement of our policy principles’](#) (July 2011).

Because the new appointments and variations 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**).

## A1 Introduction

### A1.1 Background

#### A1.1.1 The new appointments and variations framework

The new appointments and variations framework in England and Wales provides a mechanism to facilitate new entry into the water and wastewater sector and to allow incumbent water companies<sup>1</sup> to expand into other geographic areas.

The introduction of this form of competition ‘for’ the market is intended to challenge incumbents, drive efficiencies and stimulate innovation. Its aim is to benefit developers and end customers through lower prices, better quality of services, innovative, environmentally-friendly solutions and more choice.

Under existing legislation, we can appoint a new company to serve a site (for water, wastewater services or both) if one of three qualifying criteria is met:

- the **unserved** criterion – the site is not connected to the water and/or sewerage infrastructure of an existing water company;
- the **consent** criterion – an existing water company consents to the application; or
- the **large user** criterion – the premises comprising the site use at least 50ML in any year in England or 250ML in Wales and the customer(s) consent(s).

This guidance applies to all types of appointment. To date, most sites served by new appointees have been granted under the unserved criterion and relate to new residential and mixed use developments.

New developments often require the installation of on-site infrastructure which needs to be connected to the incumbent’s existing network. A property developer can do this work itself or subcontract to a third party, either the incumbent, a self-lay provider or a new appointee.

If the developer chooses a new appointee and we agree to the appointment, as well as being responsible for constructing the on-site infrastructure, the new appointee also provides services to the end customers on the site as a monopoly provider. This will include retail and other on-site services, such as maintenance of the infrastructure. In some rare cases, it may include on-site water and/or wastewater treatment.

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<sup>1</sup> In this document, we use the term ‘water company’ to refer to a company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991.

New appointees therefore compete to provide services to:

- **developers** – new appointees compete with incumbents, self-lay providers and developers to provide installation services, such as building the on-site infrastructure and connecting new properties to an incumbent's existing network; and
- **end customers** – by applying to us, new appointees compete with the incumbent to provide end customers with retail services, the operation and maintenance of the on-site assets and in some cases other on-site wholesale services.

In most cases, new appointees need to agree a bulk supply or discharge agreement with the local incumbent to ensure the supply of water and wastewater services to the site. This guidance is intended to only apply to charges under bulk supply or discharge agreements that incumbents make with new appointees.

## A1.1.2 Legal framework

### Bulk agreement disputes

Where parties are unable to agree a bulk supply or discharge agreement, we can be asked by either party to determine the terms (including the price) of the bulk supply or discharge under sections 40, 40A, 110A and 110B of the Water Industry Act 1991. In general, we expect companies to negotiate bulk agreements without our intervention.

However, the parties may fail to agree on:

- the terms of a proposed bulk supply agreement;
- how the terms of an existing agreement should be changed; or
- whether an existing agreement should end.

These disputes can therefore be about prices, duration or other terms of supply. When parties fail to agree they can ask us to determine the terms of the bulk supply. We can determine the contractual terms of actual or proposed bulk supply agreements if certain conditions are met (see sections 40, 40A, 110A and 110B of the Water Industry Act 1991<sup>2</sup>). We can only make these determinations if we are satisfied that the various parties cannot reach agreement.

Before we make a determination we must also decide that the proposal or, where appropriate, the variation or termination of the existing agreement is necessary or expedient in the case of:

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<sup>2</sup> These new sections are fully in force save as regards bulk supply or discharge agreements where both parties are one party is wholly or mainly in England and the other is (or would be if the agreement is made, in the case of a prospective new appointee) wholly or mainly in Wales, or vice versa.

- a bulk supply of water, to secure the efficient use of water resources or the efficient supply of water; or
- a bulk discharge of wastewater, for the purposes of Part 4 (Sewerage Services) of the Water Industry Act 1991.

We also have concurrent powers with the Competition and Markets Authority (CMA) to apply competition law with respect to water and wastewater activities in England and Wales. Where appropriate, we can use our competition law powers in relation to existing markets for bulk supplies to ensure they are working for the benefit of customers.

We published [guidance](#) on our approach to the application of competition law in March 2017. Decisions on whether to open or continue investigations under the Competition Act 1998 (CA98) and whether and what enforcement action we should take under the CA98 will be made using our [prioritisation principles](#).

## Charging rules

Changes to the Water Industry Act 1991 by the Water Act 2014 empower us to issue charging rules in relation to bulk agreements.<sup>3</sup>

The Water Act 2014 also gives the Secretary of State and the Welsh Government the power to issue guidance to us about the principles to be applied by us in determining the provisions of charging rules and as to the content of charging rules. Currently, these provisions are in force in relation to agreements between English companies (since 1 April 2018) and between Welsh companies (since 1 April 2019).

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](#)).

To date we have not issued charging rules with respect to bulk charges, but may choose to do so in the future, for example if we considered this guidance was insufficiently effective.

### A1.1.3 Developing our policy approach

Following a [consultation on a draft version of our guidance](#) in November 2020, we finalised this guidance on bulk charges for new appointees in January 2021. This followed from ~~We~~

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<sup>3</sup> Under section 40E of the Water Industry Act 1991 (inserted by section 8 of the Water Act 2014) in relation to bulk supplies of water and section 110F of the Water Industry Act 1991 (inserted by section 9 of the Water Act 2014) in relation to bulk discharges of wastewater. These provisions are fully in force save as regards charges under bulk ~~supply or discharge~~ agreements ~~between parties one of whom~~ where one party is wholly or mainly in England and the other is (or would be were the agreement to be reached, in the case of a prospective new appointee) ~~is~~ wholly or mainly in Wales, or vice versa.



~~published~~ our **November 2020** [conclusions on our approach to regulating bulk charges paid by new appointees](#) ~~in November 2020~~.

This was informed by a report we commissioned from economic consultants CEPA into incumbents' current practices when setting bulk charges for new appointees. We commissioned the report to explore whether their practices were driving benefits for customers, the environment and wider society and [consulted](#) on its findings in July 2020.

Incumbents were setting bulk charges with reference to our May 2018 guidance, a [new approach to bulk charges for new appointees](#). This guidance introduced the principle that bulk charges for new appointees should be set to reflect wholesale charges minus avoidable costs. The guidance followed from the 2017 study, which we commissioned from Frontier Economics, to [review the new appointments and variations market](#).

## **A1.2 Scope of this document**

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

Bulk charges are a critical part of a bulk agreement. They influence the ongoing margin and, therefore, whether a new appointee can compete to serve a site.

This guidance sets out our approach to future determination requests related to the charges in a bulk agreement between an incumbent and a new appointee. The aim is to support a level playing field in the provision of developer services and the provision of water and/or wastewater services to end customers.

Our guidance is only concerned with disputes which we would deal with under our determination powers under the Water Industry Act 1991. It does not constitute guidance on the application of competition law. Incumbents remain separately responsible for managing their own compliance with competition law. For example, incumbents holding a dominant position must ensure that their actions do not constitute an abuse of that position. Of particular relevance in this context are exclusionary behaviours, for example, setting prices which give rise to margin squeeze.

### **Other relevant guidance**

This guidance should be read in conjunction with the following guidance and documentation, as well as in the context of the relevant provisions of the Water Industry Act 1991:

- [‘Negotiating bulk supplies – a framework’](#) (August 2013) – this document provides a framework for incumbents as they consider negotiating bulk agreements. It primarily relates to the coverage of bulk agreements but does discuss price terms.
- [‘Bulk supply pricing – a statement of our policy principles’](#) (July 2011) – this document covers bulk charges between incumbents as well as those between incumbents and new appointees. It sets out the principles we will use when making determinations on bulk agreements.

## A1.3 Structure of this document

The remainder of this guidance is structured as follows:

- guidance on **our approach to disputes**, including how we will apply a wholesale minus approach; and
- our **expected behaviours of incumbents**, which sets out what behaviours we want to see from incumbents as they consider how to apply this guidance when developing and publishing their bulk charges for new appointees.

## A2 Our approach to disputes

In this section we set out the approach we expect to take to disputes relating to charges in bulk supply or discharge agreements between incumbents and new appointees.

### A2.1 Scope of bulk supply services

We will apply this guidance to any dispute about bulk charges between an incumbent and a new appointee referred to us under the Water Industry Act 1991. The scope of disputes which can be referred to us includes charges for any range of bulk services required by new appointees to provide services to their end customers.

The scope may cover both water and wastewater or, depending on the needs of the new appointee, only a subset of these services. For example, some new appointees may not require wastewater bulk services in whole or in part if they provide their own wastewater services, offer water reuse or recycling, or manage surface water drainage through sustainable drainage systems.

Some new appointees may also rely on water resources, either treated or untreated, from providers other than an incumbent, or provide their own water resources or water treatment services.

As technology evolves, the range of services required by new appointees may also change over time.

For these reasons, new appointees must be free to choose which services they wish to purchase from incumbents. Bulk charges should be flexible and relate solely to the services requested by a new appointee.

### A2.2 Our wholesale minus approach

In the case of a dispute, we will apply a **wholesale minus approach**. This approach starts from the relevant wholesale tariff(s) and **deducts costs that the incumbent would no longer incur if a new appointee supplied the site instead**.

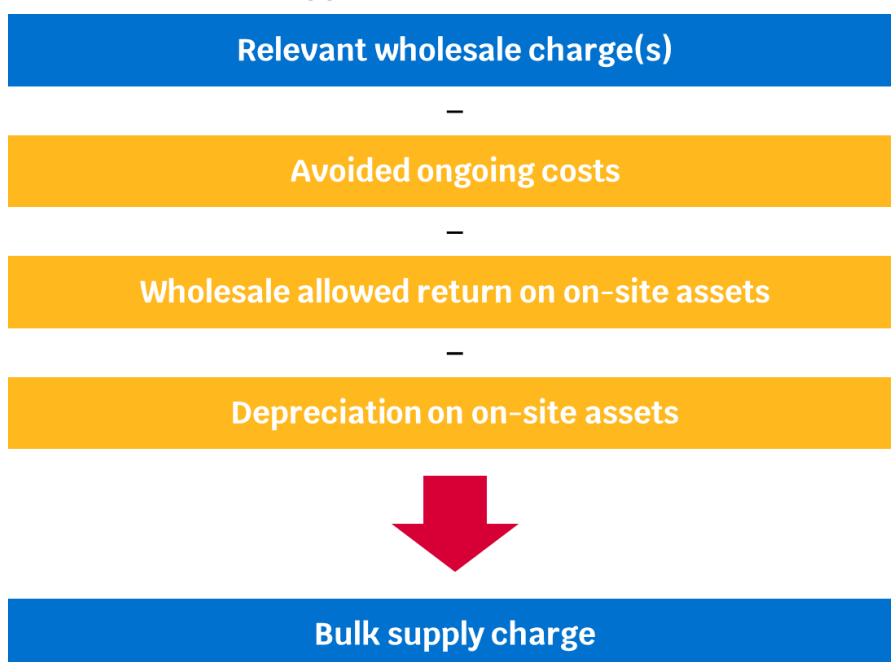
There are four essential elements in this approach:

- the **wholesale charges or set of charges** as the relevant starting point from which to deduct the relevant costs;
- the **'minus' element** which consists of the costs to be deducted from the relevant starting point. There are three categories of **avoided costs** that may apply:

- o ongoing costs;
- o a wholesale allowed return on on-site assets; and
- o depreciation on on-site assets.

Figure 1 provides a graphical illustration of our wholesale minus approach. The rest of this section provides further details on the key elements in our wholesale minus approach.

**Figure 1 – the wholesale minus approach to bulk charges**



### A2.2.1 The relevant starting point

Under a wholesale minus approach, bulk charges should closely relate to the services a new appointee provides to its end customers. In broad terms, the relevant starting point is the total incumbent’s wholesale charges that reflects the new appointee’s end customer base **on the site**. This requires creating an ‘overall weighted average’ tariff that reflects the combined wholesale charges that would be paid by the new appointee’s end customers to the incumbent if the incumbent served the site.

The bulk charges should accurately reflect the scope of **water and/or wastewater** services supplied by the new appointee on the site. It should also reflect any changes in the composition of the new appointee’s end customers, for example if a business property is replaced by a residential property.

The relevant starting point should be updated to reflect changes in an incumbent’s wholesale charges.

Charges should be produced using a ‘menu-based’ approach so that new appointees are able to calculate their bulk charges based on the actual mix and quantity of properties supplied

on a site. This should be updated on at least an annual basis, not least to reflect changes to the incumbent's wholesale charges.

For the avoidance of doubt, an incumbent's wholesale large user tariff would only be relevant in the case where there is one or more single large user of water as end customer(s) on the site.

## A2.2.2 Relevant avoided costs

The relevant avoided costs to deduct from the relevant starting point under the wholesale minus approach fall into three main elements:

- **avoided ongoing costs**;
- a **wholesale allowed return** on on-site assets; and
- **depreciation** on on-site assets.

In some circumstances, not all costs mentioned below may be relevant, or it may be necessary to deduct additional costs that reflect the characteristics of the site.

### Avoided ongoing costs

These costs relate to the ongoing costs of operating and maintaining on-site assets that are avoided by the incumbent. They must reflect the activities that the new appointee is expected to perform on the site. Most new appointees will maintain and operate the on-site infrastructure. They may also perform additional services, such as emergency responses and reading meters at the boundary of the site, which should also be deducted from the relevant starting point. Retail costs (such as billing services and reading the meters of end customers) are not recovered by wholesale charges, and as such should not be deducted.

In addition to direct costs of operating and maintaining on-site assets, an appropriate allocation of indirect costs, such as overheads, should be included in the deductions.

The ongoing costs of operating and maintaining the on-site assets should be those of the incumbent.

The maintenance costs of on-site assets are likely to change over time. We would expect to consider the level, timing and profile of all costs incurred over the lifetime of the asset, including through the estimation of an equivalent average annuity. The incumbent's historical costs could be a reasonable and practical proxy for estimating ongoing maintenance costs. These costs will cover infrastructure built at different historical times and thus the average maintenance costs could be a reasonable proxy for the lifetime on-site maintenance costs of newly-built assets.

To support a level playing field between new appointees and self-lay providers, it may be appropriate to reflect the impact of asset adoption arrangements, for example if an incumbent would not have liability for certain costs, and hence not avoid them, in the first year after asset adoption.

### **Rate of return on on-site assets**

To the extent that an incumbent would have accrued the value of the on-site assets to its regulatory capital value (RCV) if it undertook the development instead of a new appointee, a wholesale allowed return on the relevant on-site assets should be included in the costs to be deducted. This return could be equivalent to the incumbent's wholesale allowed return or be adjusted to reflect the relative risk of a new appointee compared to an incumbent.

This element is particularly relevant where incumbents partly contribute to the funding of on-site assets (for example where income offset is applied to on-site assets).

Any additional allowance should reflect the operational risk experienced by new appointees which an incumbent has avoided.

### **Depreciation on on-site assets**

To the extent that an incumbent would have accrued the value of the on-site assets to its RCV if it undertook the development instead of a new appointee, depreciation of the onsite assets should be included in the costs to be deducted.

This element is particularly relevant where incumbents partly contribute to the funding of on-site assets (for example where income offset is applied to on-site assets).

### **Costs not to be reflected in bulk charges**

This guidance does not list all the costs that should be included or excluded in setting bulk charges. However, for clarity, we consider it is helpful to specify three types of costs that should not be factored into estimating bulk charges. These are:

- **Costs recovered from developers:** The type of costs that need to be deducted from the relevant starting point are those that an incumbent would have recovered from their end customers if it served the site instead of a new appointee. This is important because upfront one-off costs are normally recovered from developers. For example, developers normally pay for the costs of rolling out the on-site network, connecting to the incumbent's network and for a share of network reinforcement. Because the upfront costs of these services are already recovered from developers they should not be recovered from end customers and should therefore not be considered for the purpose of setting bulk charges.

- **Offsite costs that are not avoided:** Incumbents may incur incremental, ongoing costs that are driven solely by the new development, for example where additional off-site pumping is required for a site to maintain water pressure; the upfront costs of installing these pumps may be recovered from developers while any ongoing running costs, such as energy used to operate these pumps, are recovered from end customers. These costs are not avoided due to the entry of a new appointee and should therefore not to be considered for the purpose of setting bulk charges.
- **Retail costs:** Because the wholesale minus approach uses an incumbent's wholesale charges as the relevant starting point, new appointees are able to recover retail costs that are equal to the incumbent's retail charges. For this reason, any retail costs that are avoided by the incumbent, such as billing services, or the reading of end customers' meters or managing the costs of customer bad debt (such as debt collection fees) should not be considered for the purpose of setting bulk charges.

## A2.3 Leakage adjustment

If the new appointee is charged on the basis of metered volumes for the whole site (rather than volumes for individual premises), then the bulk charges should reflect the expected volume of water losses between the bulk supply meter and the new appointee's customers' meters. This is an avoided cost for the incumbent when a new appointee operates the site.

This avoided cost might be reflected by applying a percentage reduction to bulk metered volumes charged for. Alternatively, and equivalently, the percentage discount can be applied as a percentage reduction in volumetric wholesale charges after all other avoided costs deductions are applied.

The adjustment for leakage in the bulk supply charge calculation should be based on an estimate of the incumbent's level of leakage for the site; not the new appointee's actual level of leakage or leakage on the incumbent's wider network.

Costs related to leakage detection and on-site repairs are also avoided costs, and should be captured under the ongoing cost deduction.

## A2.4 Other relevant charges

Other charges paid by new appointees to new incumbents may be relevant on a case-by-case basis, including to reflect site-specific environmental factors.

In this section we include guidance on other charges that may be relevant when incumbents negotiate bulk charges with new appointees.

## Surface water drainage

Wastewater companies have a duty to remove and process the water that falls on properties and then flows directly or indirectly into public sewers, which are their responsibility. This is known as surface water drainage.

The companies can levy a charge for surface water drainage, which covers the cost of taking away and treating surface water that runs from properties into the company's drains. This includes water that flows through gutters or that runs into the road and ends up in a company-owned sewer.

If any surface water from premises within the new appointee's site boundary enters into a public sewer owned by the incumbent company, then the new appointee should pay a cost-reflective surface water drainage charge. This charge should form part of the bulk supply arrangements.

We welcome innovative and more sustainable approaches from all appointees to manage surface water drainage. If the drainage system that the new appointee installs results in less surface water entering the incumbent company's sewers (either at peak times or on average), this should be recognised in the calculation of the avoided costs, and hence the price paid for the service.

## Highway water drainage

Highways England, Highways Standards (Wales) and local highways authorities are responsible for managing the drainage of run-off from motorways and the road network effectively. Section 146 of the Water Industry Act 1991 prohibits sewerage companies from charging Highways England, Highways Standards (Wales) and local highways authorities for the drainage of highways. Wastewater companies bear the costs of this highway drainage, which means that the generality of customers cover these costs through their sewerage bills.

Under the wholesale minus approach, these costs should already be accounted for in the wholesale charges used in the relevant starting point. **However, Any** material highway drainage costs that are avoided should be included in the **bottom-up** estimate of avoided costs.



## A3 Expected behaviours

In the previous section we set out our approach to disputes relating to charges in bulk supply or discharge agreements between incumbents and new appointees.

As we set out in [our review of incumbents' support for effective markets](#), and in our conclusions on bulk charges for new appointees, incumbents have an important role 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 on an ongoing basis, including the new appointments and variations market.

In this section we set out the minimum expected behaviours we want to see from incumbents as they consider how to apply this guidance when developing and publishing their bulk charges. Doing so should improve the predictability, consistency and transparency of bulk charges for new appointees.

### A3.1 Applying the wholesale minus approach

We expect incumbents to apply the wholesale minus approach set out in section 2 of this guidance when developing their bulk charges for new appointees. This includes the starting point accurately reflecting the characteristics of individual sites.

For existing agreements and sites served by new appointees prior to the publication of this guidance, we expect incumbents to consider the appropriate way to reflect this guidance. In many cases incumbents should be able to set bulk charges that reflect some or all of our conclusions and this **draft** guidance without significant rework or delay. In other cases, engagement and/or a transition period may be required.

Incumbents should ensure their approaches to cost estimation are cost reflective and only include relevant avoided costs. When estimating their avoided costs, incumbents should carefully consider which costs are relevant, using industry best practice where appropriate. The list of avoided costs that are common to most sites served by new appointees developed by CEPA in 2020 provides a useful starting point.<sup>4</sup>

The costs of maintaining on-site assets are likely to change over time. Incumbents should consider how best to estimate this, including through the use of an average annuity.

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<sup>4</sup> See appendix B of [CEPA's report](#).

## Environmental incentives

When structuring their bulk charges for new appointees, incumbents should consider potential impacts on environmental outcomes. In particular:

- bulk charges should not financially penalise new appointees for promoting greater water efficiency; in particular, the avoided cost components of charges should not be applied per volume of water supplied if the volume of water supplied is not the driver of costs; and
- the calculation of avoided costs should seek to take account of the characteristics of the site on the incumbent's costs.

Ways in which incumbents might address these issues could include one or more of the following:

- bulk charges that are wholly or substantially based on the volume supplied (with no fixed element or standing charge);
- where the avoided costs element is calculated through the use of assumed consumption levels per property;
- that reflect the extent to which surface water drainage costs would be incurred if there are sustainable drainage systems and/or other systems to mitigate surface drainage, on the site; and
- where per capita consumption is sustained at low levels (for example as a result of grey water recycling or rainwater harvesting on the site), whether additional avoided costs should be taken into account, for example relating to additional water resources.

## A3.2 Publishing bulk charges

Incumbents should publish bulk charges so that they are transparent, accessible and up to date. The information should allow prospective new appointees to confidently estimate their bulk charges when seeking to serve new sites.

When applying the wholesale minus approach, in practice incumbents should publish a 'menu' of charges so that new appointees are able to calculate their bulk charges based on the actual mix and quantity of properties supplied on a site.

The type and scope of bulk services required by new appointees will vary depending on its approach and the circumstances of a site. In some rare cases, certain sites may require bespoke charges or variations to elements of the standard charge, and this should be noted in the incumbent's bulk charges publications.

We expect incumbents to adopt best practice in producing charging information and publishing their bulk charges, including explanations of the calculation methodologies and assumptions used. Incumbents should provide the means for prospective new appointees to

independently estimate their charges for example through the use of quality-assured tariff calculators and/or worked examples.

### **A3.3 Updating bulk charges**

In future, we expect incumbents to adjust their bulk charges to ensure that they remain cost reflective. Published charges should be updated on at least an annual basis, not least to reflect updates to wholesale charges. We expect incumbents to take the initiative and tailor their bulk charges to new circumstances as soon as is practical.

It would be good practice for incumbents to review their existing bulk agreements to reflect changes to this guidance.

**Ofwat (The Water Services Regulation Authority)  
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