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Workstream 1 - Setting the relevant starting point and overall tariff approach

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The rationale for workstream 1 was to understand the range of approaches currently used to set the relevant starting point for bulk supply tariffs; identifying elements that work well and those that add complexity. The aim of the group was to develop a set of overarching principles that would help to secure consistency in the way bulk supply tariffs are set by water and wastewater incumbents; with the ultimate intent of establishing a simple, transparent process that facilitates production of accessible, user-friendly charging documents that are informed by agreed best practice.

In January 2021, Ofwat issued guidance to the industry regarding the way that bulk supply charges should be calculated¹. The guidance specifies that incumbent water and wastewater companies should take, as their starting point, the relevant wholesale tariff. Ofwat also specifies that the relevant starting point should be an overall ‘weighted average’ tariff reflecting the end customer population on the site e.g. the split of household and non-household properties.

The relevant starting point can therefore be considered to represent the combined wholesale charges that would be paid to the incumbent by the end customers on the site if the incumbent owned and operated the last-mile network; prior to the deduction of any avoided costs. For the majority of NAV sites, any non-household demand is unlikely to be sufficiently large to qualify for a large user tariff and therefore in practice the relevant starting point will mostly be based on the published household tariffs. No matter the specific composition of the site, the avoided costs within this context, should be taken to mean any avoided long run incremental costs (LRIC) that the incumbent would have faced if it were to serve the site rather than a NAV.

In addition, Ofwat’s guidance specifies that, once this relevant starting point has been identified, the incumbent company should apply a ‘wholesale minus’ approach to calculate cost-reflective NAV bulk supply charges. This approach incorporates two key costs. This first is the wholesale costs that the incumbent would no longer incur, due to the presence of a NAV serving a given site and the second is a portion of the incumbents central costs that would theoretically be apportioned to the specific site if the incumbent were to serve it. Both elements would be deducted from the relevant wholesale tariff to attain a bulk supply charge that reflects the competitive dynamics in the market.

1. Setting the scene: The diversity of tariff composition

Workstream 1 meetings commenced at the end of May 2021 and comprised five separate sessions that were held monthly until September 2021. During initial workstream discussions, it became apparent that there was a significant amount of diversity in terms of the approach that individual water and wastewater companies take to setting their tariffs. The group made the following observations with respect to the composition of NAV bulk supply tariffs that were published by incumbents for the 2021-22 regulatory period.

- **Relevant starting point:** Incumbents took one of four approaches to define the relevant starting point for their NAV tariffs. Most incumbents based the relevant

¹ [Bulk charges for new appointees – guidance on our approach and expectations](#)

starting point on their household tariff while a number based it on a mix of their household and non-household tariffs and a couple didn't provide this detail in their charging documents. While this demonstrates a degree of consistency in the approach of using the household tariff to determine the relevant starting point, this approach was not adopted universally.

- **Treatment of household and non-household customers:** Incumbents took one of five approaches to the development of tariffs for different end-user types. Most incumbents established different tariffs for household and non-household users. The remaining incumbents adopted a mix of approaches including some form of flat volumetric approach, an approach based on the number of plots and approach that used the household tariff as the sole basis for all charges. As above, while there is a degree of consistency in the approach this is not universal and, coupled with the diverse approaches to the relevant starting point, it demonstrates that fully understanding incumbent tariffs can be challenging.
- **Tariff composition:** This category refers to the various components comprising the end-user tariff e.g. a fixed credit per plot plus a volumetric charge or a simple volumetric charge. This category is where the extent to which there is diversity between different incumbent tariffs is most apparent. In this respect, incumbents took one of 12 approaches, with only one approach being common to more than two incumbents; this involved defining a fixed credit per property / volumetric charge by region and was taken by six incumbents.
- **Tariff composition for non-household volumetric charges:** This category refers to the way that volumetric charges are applied to different levels of non-household usage. In this area, all incumbents took a tiered approach but the basis for this approach differed across them.

Clearly this level of diversity in the presentation and composition of tariffs can create complexity for NAVs in effectively engaging with, deciphering and interpreting the charging documentation of each incumbent water and wastewater company. Where some standardisation could be brought to the structure of NAV tariffs, this would effectively simplify the associated tariff setting process for NAVs. In this respect, if all incumbent NAV tariffs conformed to the same overarching structure and were calculated using similar principles, this would allow NAVs to clearly identify the respective components of incumbent tariffs and easily assess these against their own in-area costs. In effect, NAVs would no longer be required to translate 24 different tariffs into a common format and would avoid the need to make assumptions around exactly how certain tariffs are composed. The resulting like-for-like tariff comparison completed as part of the tariff-setting process would be far less resource-intensive but would provide NAVs with confidence that they had accurately assessed incumbent tariffs against their own and would not be subject to any unanticipated costs.

In taking forward any such initiatives or specifying associated requirements, a balance needs to be struck between reducing complexity and providing incumbents with sufficient flexibility and discretion to determine how they set their tariffs. However, the group agreed that tangible benefits could be delivered from bringing some level of standardisation to the structure of NAV tariffs.

2. Objectives of the working group

A key focus of the initial workstream discussions was to establish the key objectives the working group should seek to fulfil; and two objectives were agreed.

1. To develop high-level principles for the overall approach to setting bulk supply tariffs.
2. To collate best practice guidance with respect to the calculation of the relevant starting point for bulk supply tariffs; issues covered may include, but are not limited to, the weighted average methodology, site specific avoided costs and use of the Large User Tariff.

The following sections provide an overview of the key conclusions in both these areas. During the working group discussions reference was also made to the treatment of social tariffs within the overarching framework established for bulk supply tariffs and a question was raised about whether it should be addressed as part of this initiative. While members of the group recognised this as an important issue to resolve, they also noted that it was a retail issue that did not fall within the direct scope of these discussions, given that the relevant starting point for NAV tariffs is based on wholesale costs. Recognising its importance however, agreement was reached that social tariffs should be included within any future discussion of the bulk supply framework.

3. Objective 1: Principles for setting bulk tariffs

During the working group discussions, an overarching principle for setting bulk supply tariffs was identified: ***Optimise the range of tariffs offered and the associated cost categories to facilitate the establishment of a more standardised set of NAV tariffs, applicable across different sites.*** Inclusion of the term 'optimise' within this principle recognises the benefits that reducing the number of tariffs could have in terms of facilitating simplicity, while acknowledging that the incumbent tariffs available should reflect the range required to deliver a minimum set of necessary services. Within this overarching principle, the working group identified the following more directive principles that provide practical guidance as to how this key objective could be put into effect.

1. **Bulk tariffs should be simple, clear and not onerous to calculate / apply:** Each incumbent should establish a standard household-only NAV tariff and a schematic for mixed household / non-household sites that would allow NAVs to determine relevant site-specific tariffs. In both cases, the components of these tariffs should be customers that is simple, clear and relatively easy to apply across all of its NAV sites. This would provide clarity to NAVs about the cost per customer-type that each incumbent would charge within its bulk supply tariffs.
2. **Tariffs should be structured using a menu-based approach:** Each incumbent should establish standard tariff costs it will charge across a discrete set of site-specific cost categories that will be applied where certain characteristics are evident on a NAV site. Cost categories should be optimised and, where practical, limited to a predefined set that is sufficient to reflect the additional wholesale activities that the incumbent could avoid.
3. **Bespoke tariffs should be the exception:** The move toward the use of weighted average tariffs that reflect the end customer population on a NAV site could be interpreted as requiring bespoke tariffs for each NAV site. However, during working group discussions, we agreed that tariffs should conform to the principles and best practice guidance set out in this paper as far as possible; with bespoke tariffs the

exception not the rule. We recognise that if a site has specific identifiable characteristics that materially impact the relevant starting point or costs, e.g. a non-household customer on a large user tariff, this should be accommodated by the NAV tariff. However, differences in site characteristics that have only a marginal impact on costs e.g. the proportion of HH versus NHH customers, should not necessitate a bespoke approach. We are concerned that this would become increasingly unworkable as the volume of NAV sites increases and could impose a disproportionate administrative burden if incumbents were required to produce annual site-by-site charging documents. Combined application of principles 1 and 2 should mean it will be possible to objectively define tariffs based on the particular characteristics of a site e.g. number of plots, number of large users and any other site specific adjustments.

4. Objective 2: Best practice guidance on setting the relevant starting point

Once the working group had agreed recommended principles for setting bulk tariffs, discussions turned to associated recommendations around best practice in applying these principles. The group recognised that the tariff arrangements were still evolving and that best practice guidance would therefore be necessarily high-level. However, as experience of applying the principles outlined above increases, these best practice examples will evolve and may become more prescriptive, particularly if consensus is reached on aspects of the process that work well and those that perform poorly. At present, the best practice approaches that the group recommend as part of this paper fall into the two following categories.

1. **Publication of Standard Bulk Tariffs:** All incumbents must develop and publish a standard bulk tariff that is simple, clear and relatively easy to calculate / apply. Bulk tariffs may comprise a standing charge and volumetric rate or simply a volumetric rate but, no matter the composition, they must clarify tariff bandings for different development sizes and, where applicable, regional wholesale tariff variations.
2. **Menu of Site-Specific Adjustments:** Recognising that each site has different characteristics that are not limited to the size and location of the development, incumbent charging arrangements must also provide for required site specific adjustments. These could take the form of adjustments to the relevant starting point, either to reflect additional costs that the incumbent would incur as compared with assumed costs included in the standard bulk tariff or additional costs that the incumbent would avoid. These adjustments to the standard bulk tariff, where required, may reflect the characteristics of the site e.g. the types of end users on the site and their needs, or NAV decisions to provide certain onsite assets / services in-house. The following sections provide an overview of these two scenarios.
 - a. **Site characteristics differ from assumptions underpinning the standard bulk tariff:** An incumbent's standard bulk tariff will be based on assumptions about the main features of a site e.g. the types of customers and their service requirements. Where the actual site characteristics differ from the base case, this could lead to the incumbent incurring or avoiding additional costs (over and above those incorporated in the standard bulk tariff). To reflect the split in the balance of costs incurred, provisions should be included in the relevant NAV tariff to allow for these departures. For example, where a large user is located on the site, the relevant starting point will need

to be adjusted to reflect that this customer will benefit from a large user tariff. In this case, the large user may also be an industrial customer that needs to make use of trade effluent services and the NAV tariff should reflect the additional cost of these services. In addition, adjustments may be needed where a site is different from the assumed site characteristics underpinning the standard bulk tariff e.g. due to the length of mains laid per household connection.

- b. **Assets constructed / services provided by the NAV:** An incumbent's standard bulk tariff will include assumptions about the basic assets that a NAV will construct and the onsite services they will provide. If the suite of assets and associated services that the NAV provides in-house differs from this base case, it could lead to the incumbent incurring or avoiding additional costs. For example, a NAV may choose to install pumping stations, boosters or other equipment leading to a reduction in the cost that the incumbent faces. The NAV could also assume additional responsibilities e.g. ownership of offsite mains leading to a cost reduction for the incumbent. Equally, if a bulk meter was installed to measure consumption onsite, the relevant starting point or volumetric consumption would need to be adjusted to provide for an onsite leakage allowance. And, if the site included SuDS or onsite drainage owned by the NAV, incumbent costs associated with usage of surface water drainage services would be reduced. In each of these cases, an adjustment to the standard bulk tariff would be needed to reflect the scope of services that the incumbent actually provided on a given site.

Discussions during the working group indicated that these were the main categories of cost where an adjustment to the relevant starting point may be needed. However, we recognise that this may not be exhaustive and that additional best practice examples may be identified, particularly over time as these arrangements gradually become more established.

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