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Ofwat NAV Policy

By email

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RE: Consultation on bulk charges for New Appointments and Variations (NAVs) – Wessex Water response

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

We agree that a menu-based approach to creating a weighted average of tariffs provides the most transparent and accurate tariffs.

Q2: Do you agree that large user tariffs should not be offered for new NAV sites? What should the approach be to existing sites?

We note that there is some ambiguity in this question regarding whether we are discussing the “new sites” or “sites that are newly served by NAVs”. We consider both options below and believe that different approaches should be applied depending on the condition under which the NAV is entering the market.

If a NAV is entering under either the “unserved” or “consent” condition, then we agree that large user tariffs are not appropriate and should not be offered.

However, if a NAV is entering under the large user condition, and serving only one large user, then we think they should remain on the large user tariff. In this case we will not be avoiding any additional cost or moving any liability for assets to the NAV, and so moving to the NAV charges would be inappropriate.

For existing customers, consideration needs to be given to the commercial arrangements and contracts that exist between the parties. These often set out the rules for future price changes and will have underpinned the business cases of the NAVs.

Q3: Do you agree that incumbents should use bottom-up approaches to estimate costs, or would more granular accounting segmentation be more appropriate?

We currently assess costs using what is referred to in the CEPA report as a ‘middle down approach’. We look at our fully allocated costs, split out across our network, and consider which part(s) of our network a NAV would be operating instead. These costs are what we consider to be the avoided costs.

We do not think that a mandated move to bottom up pricing is appropriate here.

1. There is benefit in publishing a standard figure to allow NAVs to calculate an indicative upfront charge. This will aid in their optioneering and consideration of potential new sites.
2. A bottom up estimation based on what is actually being built, rather than how an incumbent would do it, could create a disincentive for NAVs to innovate and seek more efficient ways of serving developments

We do accept that, depending on the specific site, this may not be appropriate and so would suggest the flexibility to move to a bottom up estimate. Specifically, with regards to hard to serve sites where there are significant offsite constraints that are not dealt with through the infrastructure charges

Q4: Do you agree with CEPA's list of common avoided costs or should additional items be included? Should we incorporate this list in our guidance?

As we disagree with the move to bottom up pricing, we do not think that this approach should be mandatory. We also have some concerns that the approach here, in setting a fixed value per driver for these items, is not true bottom up pricing – it is much more akin to a middle down, averaging approach.

However, we do see some value in listing the common costs that would be avoided to ensure some form of comparability across the industry – however, this would necessarily be a non-exhaustive list and a rough guide, rather than a formal requirement.

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

We agree that indirect costs should be included in the overall avoided costs.

We do this in our current approach by analysing ex-post fully allocated actual costs.

On an ex-ante analysis of bottom up costs this will be more speculative and will rely on proportionate allocations inferred from the ex-post top down analysis.

Therefore, we support setting costs following a top down approach to simplify the inclusion of indirect costs.

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

Overall, as the industry now operates on a totex basis, we think that this should be included in the assessment of the avoided costs rather than a separate section.

Specifically, regarding maintenance though, we do have some thoughts:

As we discuss in our response to the regulatory reporting consultation, we think that it is important to understand the actual maintenance costs NAVs are incurring, through the small company APR return. This will provide better information for future NAV tariffs.

Care needs to be given here to how maintenance is funded through the regulatory framework. If all the assets a NAV operates are infrastructure assets, then the entirety of this will be considered in the avoided cost section (as infrastructure renewals are generally reported as opex and funded as fast money). If the renewals included in the avoided opex cover all the assets no further consideration here is required.

However, for other, non-infrastructure, assets we think the most appropriate way to fund maintenance would be to mimic the funding of capital maintenance through the regulatory framework.

That is, we look at the asset value of these assets and apply standard RCV run off rates to it to calculate an annual maintenance charge. This ensures that tariffs remain stable and predictable and that NAVs will collect the appropriate amount of cash over time to fund major asset renewals.

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

We agree with the proposed approach and our comments on the English situation also apply.

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

We agree that as no assets would be added to the RCV, there are no avoided returns in a wholesale minus approach. However, this then means that a NAV operating as efficiently as an incumbent no longer makes a return, particularly if we move to a bottom up calculation of avoided costs.

Therefore, we agree with the principle that some additional “return” element is required to remunerate the operational risk that NAVs are taking by serving a site.

We considered the options put forward by CEPA in their report for Ofwat. Our views are:

- As all the assets are paid for upfront, NAVs do not need to put up equity to enter the market, therefore any form of equity-based return is not appropriate.
- As we are doing a wholesale minus approach, looking at the actual capital employed by NAVs is a divergence from this approach.
- Looking at avoided capital costs does not remunerate risk and would, in our opinion, be included in the avoided indirect costs.

Therefore, we favour straight margin-based approach. This does leave us with the issue of setting a margin.

To do this we considered the margins that are used in other areas of the value chain.

The household retail market operates on a 1% margin. However, we believe that there is greater risk here than that.

At the same time, NAVs do not take a lot of the risks that an incumbent would. There are no risks around asset construction and its financing, there are reduced regulatory risks, and there are reduced operational risks with no performance commitments and ODIs.

Therefore, we would propose to incorporate a 2.5% margin on the cost of sales. This was the margin that was set to foster competition at the opening of the non-household retail market.

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

We agree with this in principle; however, we cannot think of a fair way to enact this and so would strongly oppose including this in the formal guidance.

We have considered three potential approaches however each has issues that we cannot resolve.

1. An approach that guarantees the margin element on sales that a water company would expect on a given site. This would not penalise them for saving water, however it would still not incentivise them to do so. We struggle to define the counterfactual consumption and then how to monitor and asses this going forwards.
2. An approach that moves from a variable rate to a fixed charge. We struggle to define the fair method to calculate this.
3. Considering more avoided costs. This doesn't work due to the requirement that infrastructure charges be cost reflective with network reinforcement.

In the longer term we think the best way to deal with this would be for NAVs to have their own price limits, set by Ofwat.

Q10: Do you agree with the principle that NAVs should have discounted charges if they deliver sustained lower per capita consumption (and similarly improved outcomes with respect to rainwater volumes and sustainable drainage) based on avoided costs or environmental impact mitigated?

NAVs will see some of this saving come through a reduction in infrastructure charges.

We agree in principle that if a NAV can help us avoid significant investment at treatment centres then there should be an avenue to consider this. However, in the specific example in the question, their consumption would have to be guaranteed. Otherwise we would have to develop these resources to provide sufficient resilience and there would be no avoided costs to share.

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

No specific comments.

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

We agree that not publishing formal charging rules it the best way to proceed. Guidance is sufficient and we will reflect this in setting our charges.

We would support industry-led innovation in this area, however we would need to be mindful of any competition law issues around this.

Although we agree that guidance is appropriate rather than formal charging rules, on page 24 you mention that updated guidance for 2021-22 will be published in December of this year. This is far too late to impact 2021-22 charges. We agree our charges with our board (except for the November CPIH impact) in November. Which means that by the end of October it is too late to make wholesale changes in approach.

We will be consulting with NAVs about the evolution of our tariffs in September. In our consultation, we will be outlining this consultation and our response. We will then factor our consultation and their responses into our final charging methodology for 2021-22.

If you have any questions or would like further clarifications, please do not hesitate to contact me.

Kind regards,

Matt Greenfield

Director of regulation