WESSEX'S APPROACH TO SETTING BULK CHARGES FOR NEW APPOINTMENTS AND VARIATIONS (NAVs)

Peer review by Frontier Economics

November 2022

1 Scope and method of our assessment

Frontier Economics were commissioned by Wessex Water to peer review its revised methodology for setting bulk charges for New Appointments and Variations (NAVs) in 2023/24. In particular, the aim of this work was to assess whether the Wessex approach complies with the most recent bulk charging guidance for new appointees issued by Ofwat[1, 2, 3], emerging best practice from the Bulk Charging Working Group (BCWG)[4], as well as its obligations under the application of the Competition Act 1998[5].

The scope of this work is limited to a review of Wessex's bulk charging methodology and a high level review of its underlying bulk charges model only. A technical review has been separately commissioned for a formal assurance of the efficiency of inputs, calculations and accounting approach.

The latest version of Wessex Water's *Bulk Charges for NAVs Method Statement* will be published alongside the NAV charges document in February 2023. This document incorporates changes based on recommendations from Frontier Economics.

2 High level summary of Wessex's approach

Wessex Water employs a wholesale minus approach to calculate the relevant bulk charges. This approach starts with the relevant incumbent wholesale tariff(s) for the NAV's site, and then deducts the avoided costs that the incumbent no longer incurs where the NAV supplies the new development site instead (the local network).

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[1] Ofwat, January 2021, Bulk charges for new appointees – guidance on our approach and expectations

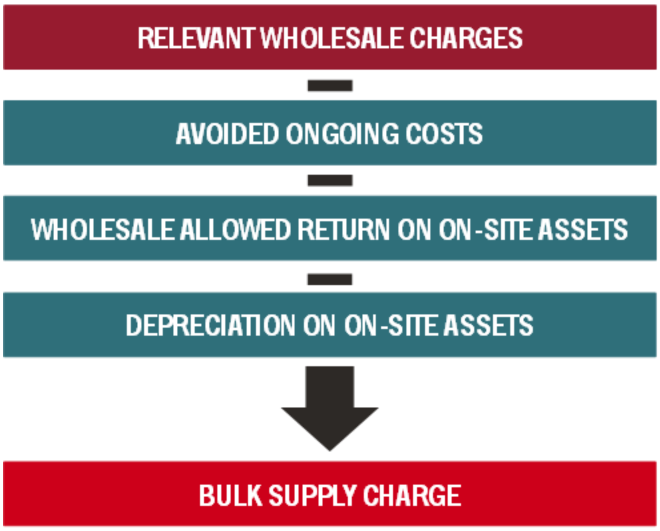
[2] Ofwat, January 2021, Bulk charges for new appointees - conclusions on revising our guidance

[3] Ofwat, September 2022, Information notice: Expectations, assurance and information requirements for water company charges for 2023-24

[4] Ofwat Bulk Charging Working Group, August 2022, Setting the relevant starting point and overall tariff approach

[5] UK Competition Act, 1998, and other Enactments (Amendment) Regulations 2004 (S.I. 2004 No.1261)

Figure 1 The wholesale minus approach to bulk charges



Source: *Ofwat, Bulk charges for new appointees – guidance on our approach and expectations, January 2021*
Note: *https://www.ofwat.gov.uk/publication/bulk-charges-for-new-appointees-guidance-on-our-approach-and-expectations/*

2.1 Relevant wholesale charges

- Wholesale charges, reflecting the new appointee's end customer base, form the relevant starting point for calculation.
- A weighted average tariff is calculated based on different types of end-customers on the site, including households and non-households.
- A final site-specific fixed charge is applied for water to recover the cost of the single bulk meter, based on the total expected water consumption.
- Wessex accounts for different discharge arrangements (foul, Surface Water Drainage (SWD) and Highway Water Drainage (HWD)) to inform the relevant starting point.

2.2 Avoided ongoing costs

The avoided ongoing cost categories considered in this methodology are direct operating costs, direct capital maintenance costs and central costs.

The key development in the 2023/24 methodology is a shift away from a 'top-down' towards a 'bottom-up' approach for calculating the avoided costs, particularly with reference to direct costs. Wessex's bottom-up approach for 2023/24 considers the costs avoided on an activity-by-activity basis, at an asset level, with reference to the historic accounting costs relating to each.

These ‘bottom-up’ unit cost estimates can be scaled up based on key cost drivers to find a total cost per user. Wessex has selected the cost drivers in Table 1 as the appropriate cost drivers for each key asset provided by the NAV, as well as other potential cost drivers that Wessex considered.

Table 1 Cost drivers considered and used, water and waste

Category	**Breakdown**			
Asset area	Mains / Sewers	Communication pipes	Meters	Pumping stations (water / waste)
Cost drivers considered	• Volume – water / sewerage • No. of properties • km of main / sewers	• Volume – water • km of comms. pipes • No. of comms. pipes km of main / sewers	• Volume – water • No. of meters	• Volume – water / sewerage • kW of pumping stations • No. of pumping stations
Final cost driver	**Km of main / sewers**	**No. of comms pipes**	**No. of meters**	**kW of pumping stations**

Source: Wessex Water Bulk Charges for NAVs Method Statement

All avoided cost elements, including direct capital maintenance costs, are calculated with 3-year averages. This was considered to be a reasonable balance between on the one hand, smoothing inherently lumpy expenditure profiles, and on the other, a simple and easily-applied measure of costs. Wessex’s Methodology Statement for 2023/24 states that it will move to a 5-year averaging approach for 2024/25.

All central overheads have been allocated on a top-down basis, to acknowledge the notional incremental central cost increase that would be observed if a significant number of sites were to be taken on by NAVs, scaled to a single NAV site.

Wessex includes a working capital adjustment to acknowledge where a NAV may need to incur capital maintenance expenditure in advance of receiving revenue for any one particular year. This is calculated using annual capital maintenance expenditure for the site multiplied by a cost of capital relevant for a NAV (NAV WACC). Details of the NAV WACC are set out in the following section.

2.2.1 Allowed return

Initially, there are no avoided returns as the assets on a new development site are fully funded by the developer.

However, Wessex allocates some amount of allowed return in their charges, in recognition of the risk taken on by a NAV when taking on a new site. This allowed return rate is calculated as a ‘NAV WACC’, based on the methodology set out by Ofwat in its bulk charges for NAVs guidance, updated with PR19 values.

This 'NAV WACC' is multiplied by the asset replacement values for each non-infrastructure asset type on a NAV site (aligned with the approach used for direct ongoing costs), for non-infrastructure assets which, if owned by the incumbent, would have been added to the RCV.

2.2.2 Depreciation

Initially, there is no avoided depreciation as the assets on a new development site are fully funded by the developer.

For non-infrastructure assets, Wessex includes a return for capital maintenance (see above) instead of depreciation, which is considered to be a broadly equivalent cost.

2.2.3 Leakage allowance

Volumes recorded at the bulk meter are adjusted downwards by 5.5% to account for any on-site leakage. This percentage has been calculated using a theoretical asset model over a horizon of 60 years to average lifetime leakage.

2.2.4 Menu-based approach

Wessex's menu-based approach scales the avoided costs to the number of properties (household and non-household) for NAV site, with a menu option for pumping station capacity.

A notional NAV site is used for setting charges, rather than an approach which is more bespoke and site-specific, to balance the complexity and administrative burden that this latter approach would require in terms of data provision by NAVs.

3 Wessex's approach is consistent with Ofwat guidance and is moving towards the developing best practice

3.1 Summary of Ofwat's 2021 guidance

The Ofwat guidance (January 2021)[6] is relatively high-level. In general, is states that the approach for incumbents should include

- the wholesale minus framework (see also Figure 1);
- the relevant starting point for the tariff which reflects the NAV site split of household and non-household;

[6] https://www.ofwat.gov.uk/wp-content/uploads/2021/01/Bulk-charges-for-new-appointees-guidance-on-our-approach-and-expectations.pdf

- a menu approach to costs to be site specific as part of this starting point; and
- a bottom-up approach.

The approach is focused on using the incumbent's avoided costs, but Ofwat guides that there can be consideration for NAV specific cost of capital, an adjustment for NAV specific operational risk and/or adjustments to recognise specific environmental issues or innovative approaches. This creates a natural tension between not using bespoke prices (which are difficult for NAVs to understand and compare) and addresses these issues on a case-by-case basis.

3.2 Wessex is consistent with the Ofwat's 2021 guidance

In our view, Wessex's approach is consistent with Ofwat's 2021 guidance and we provide one recommendation for improving the lifetime asset approach to calculating ongoing avoided costs.

Wessex takes a wholesale minus approach, using a relevant starting point of the household and non-household tariffs on the basis of the NAV site.

There is not explicit guidance on what a menu-based approach should be. Our understanding is that Wessex has received feedback from NAVs that a simple approach is most helpful. Wessex's menu-based approach allows discrete cost building blocks for the number of household properties, the number of non-household properties and the capacity of pumping stations on the site. It would be possible to include more discrete cost building blocks that would require more inputs from a NAV, or less simple inputs (such as length of mains rather than number of properties). Our view is that Wessex has taken a reasonable approach to balancing site-specific properties and providing simple options that facilitate competition from NAVs.

Wessex uses a bottom-up approach to costs, identifying appropriate cost drivers for the avoided costs. There is not specific guidance on which are the appropriate cost drivers to use and Wessex clearly sets out the justification for using kilometres of main / sewers; number of communications pipes; number of meters and the kW capacity of pumping stations. Wessex has included a portion of central costs, which have been pro-rated using the asset-based cost driver.

Wessex uses an average of three years of data for the avoided costs. As Ofwat guidance says that average maintenance costs can be used as a proxy for lifetime smoothed maintenance costs, in our view Wessex's approach to averaging across three years is not clearly inconsistent as Ofwat is not specific on this point.

However, we recommend that a longer time period for the averaging may be more appropriate, potentially giving greater consideration to the regulatory cycle and that Wessex should continue to consider ways to reflect the smoothing the costs over the whole asset life.

We note that Wessex's approach to calculating annualised lifetime leakage adjustment for avoided ongoing costs takes this approach.

Wessex includes a return for non-infrastructure assets and an adjustment for capital maintenance expenditure. There is limited specific guidance on these points beyond considering where the NAV cost of capital may be different to the incumbent's, which the Wessex approach is consistent with. Including a return on capital maintenance is consistent with a very long term view on avoided costs.

Our understanding is that Wessex's decisions and behaviours are consistent with Ofwat's expected behaviours for incumbents:

- Wessex has committed to publishing annually and providing a calculator for NAVs, and an example of how this works
- The method statement is clear and transparently sets out Wessex's approach
- Wessex has committed within its method statement to ongoing and regular engagement with NAVs to actively support the market

3.3 Best practice is still emerging

The Bulk Charges Working Group (BCWG) has published three pieces of information on the relevant starting point, the list of avoided costs to consider and appropriate framework to use. In our view, Wessex has shown evidence of moving towards best practice although we note that best practice is an emerging and evolving concept in many places. Changes that Wessex has made to move towards best practice include a bottom-up approach to estimating avoided costs, including avoided costs for surface water drainage and highway drainage and providing a clear and transparent method statement.

3.3.1 The relevant starting point

The BCWG has consensus that a best practice approach has simple and clear bulk charges, with a menu-based approach and with bespoke tariffs as the exception. Our view is that Wessex's approach is consistent with these principles, noting that there is not yet a consensus on discrete set of cost categories should make up a menu-based approach. There is also consensus that incumbents should publish clear tariffs, which we also agree Wessex's method statement is in line with.

There is not yet an emerging consensus on whether using household tariffs can be appropriate where there are limited differences to non-household tariffs, or a very limited number of non-household properties on the site.

There is also no consensus around which cost drivers are most appropriate for each avoided ongoing cost, including on whether volume is an appropriate cost driver.

3.3.2 Avoided costs

The BCWG has identified a comprehensive list of avoided ongoing costs that incumbents should consider, but no best practice consensus if each is an avoided cost and what the appropriate cost driver is.

Wessex's updated approach for 2023/24 includes specific avoided costs for surface water drainage and highway water drainage, in line with this BCWG list of costs. Wessex has also revised its cost groupings to be consistent with the groupings in this BCWG list.

This list of avoided costs to consider includes working capital. There is not yet consensus on whether this is an avoided cost or how best to estimate it.

3.3.3 Framework for setting charges

The third output uses the list of avoided costs to set out a general framework for considering costs and calculating the avoided costs. Wessex's approach considers all costs identified and the relevant cost drivers. Our view is therefore that Wessex is in line with the best practice framework, noting that consensus around exactly which costs are included in the avoided costs calculation and how to estimate them has not yet been determined.

4 Wessex's approach is not inconsistent with the principles of competition law

We considered Wessex's obligations under the application of the Competition Act 1998[7] . In particular, we considered Wessex's approach to setting bulk charges from whether it could constitute:

1. Abuse of dominant position through market power by sustaining significantly higher prices, reduced output or reduced quality compared to competitive outcomes

7 Including the 2014 addition of the concurrency regulations

2. Abuse of dominant position through conduct impairing or distorting competition, including through refusal to supply[8]

We consider Wessex's approach is not inconsistent with the principles of competition law. In particular, the method statement is clear that Wessex is open to engagement with NAVs and will give consideration to its approach for specific services and innovative services (including for environmental concerns).

Wessex's approach to a bottom up estimation of the wholesale minus approach is not inconsistent with reaching a competitive outcome, noting that we are not assuring the level of the costs or providing technical assurance of their calculation. We do not identify any intent to provide any different level of quality of service in Wessex's approach.

We also see evidence of approaches being taken that are pro-competition in its approach, for instance the use of a NAV-specific cost of capital, and the inclusion of the working capital allowance for capital maintenance on non-infrastructure assets.

We see the approach to a simple menu-based approach with discrete cost options of number of properties and capacity of pumping stations as a reasonable balance between setting cost reflective charges and providing a simple, clear framework to enable competition. We do not see Wessex's approach as inconsistent with the principles of competition law.

8 We note that the Bulk Charges Working Group is considering how to build best practice without any cartel behaviour. We have not explored this in our assessment.

5 Conclusions

Subject to the limitations of our peer review and the high-level nature of Ofwat's guidance, we consider that Wessex's approach for setting bulk charges for new appointments and variations and its approach to explaining them to stakeholders in its method statement is

- in line with the latest guidance available,
- has made progress towards aligning to the current industry best practice (which we note continues to evolve), and
- not inconsistent with the economic principles of competition law.

Going forward, we consider that a longer time period than the current three years for the averaging of costs may be more appropriate for the calculation of direct ongoing capital maintenance costs, to give greater consideration to the level, timing and profile of all maintenance costs incurred over the lifetime of the asset. This would also potentially give greater consideration to the length of the regulatory cycle. We recommend that Wessex continues to consider ways to reflect the smoothing the costs over the whole asset life.

Annex A References

- Ofwat, September 2022, Information notice: Expectations, assurance and information requirements for water company charges for 2023-24 https://www.ofwat.gov.uk/publication/in-22-03-expectations-assurance-and-information-requirements-for-water-company-charges-for-2023-24/

- Ofwat Bulk Charging Working Group, August 2022, Setting the relevant starting point and overall tariff approach https://www.ofwat.gov.uk/wp-content/uploads/2022/08/Sub_Group_1_Relevant_starting_point_principles.pdf

- Ofwat, January 2021, Bulk charges for new appointees – guidance on our approach and expectations https://www.ofwat.gov.uk/wp-content/uploads/2021/01/Bulk-charges-for-new-appointees-guidance-on-our-approach-and-expectations.pdf

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- CEPA, April 2020, Bulk Charges for New Appointments and Variations (NAVs) Regime in the Water Industry in England and Wales https://www.ofwat.gov.uk/publication/bulk-charges-for-new-appointments-and-variations-navs-regime-in-the-water-industry-in-england-and-wales/

- Ofwat, March 2017, Guidance on Ofwat's approach to the application of the Competition Act 1998 in the water and wastewater sector in England and Wales. https://www.ofwat.gov.uk/wp-content/uploads/2017/03/Guidance-on-Ofwats-approach-to-the-application-of-the-Competition-Act-1998-in-the-water-and-wastewater-sector-in-England-and-Wales.pdf

- UK Competition Act, 1998, and other Enactments (Amendment) Regulations 2004 (S.I. 2004 No.1261) https://www.legislation.gov.uk/uksi/2004/1261/contents

- Wessex Water Bulk Charges for NAVs Method Statement

- Wessex Water bulk charges model for 2023/24 (not published)