

**SOUTH WEST WATER
BULK CHARGES FOR NAVS
2021/22
Consultation on Proposals
December 2020**



SOUTH WEST WATER

Bulk Charges for NAVs 2021/22 - consultation on proposals

About this document

We first published our Bulk Charges for NAVs (New Appointments and Variations) for the charging year 2019/20. Our aim throughout has been for charges that are compliant with the Ofwat's May 2018 guidance to incumbent companies, but also transparent, simple to understand and straightforward to apply.

Since 2019 we have developed our thinking through observations of the market, and recently in respect of Ofwat's consultation and supporting analysis by CEPA.

This consultation lays out our thinking to date, and, having taken our learning and Ofwat's consultation and subsequent conclusions into account, presents proposals for refining our existing methodology.

Responding to this consultation

We welcome responses to our questions by close of business on 22 December 2020. Please send your response to NAV@southwestwater.co.uk

We will publish an anonymised summary of comments received and our response on our website.

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1 Introduction

The New Appointments and Variations (NAV) regime was introduced under the Water Industry Act 1991 (WIA91) to provide a mechanism to facilitate new entry into the water and wastewater sector and to allow appointed undertakers (incumbents) to expand outside of their geographical area of appointment.

Following a review of the NAV market and a subsequent consultation, in May 2018 Ofwat published its final guidance on pricing for bulk supply services provided to NAVs in England and Walesⁱ. The guidance sets out the principles Ofwat will use when making determinations on bulk agreements, and places requirements on incumbent companies for the publication of charges that NAVs can use to estimate bulk supply charges ahead of bidding for developer work.

In July 2020 Ofwat consultedⁱⁱ on proposals to refine the guidance. The consultation was supported by a detailed analysis by CEPAⁱⁱⁱ of incumbent companies' 2019/20 charges. Ofwat committed to considering responses to the consultation and consult on any changes to the guidance late in 2020. Consequently, Ofwat issued its conclusions^{iv} and consultation^v on revising its guidance on 10 November 2020.

We have carefully considered CEPA's paper and Ofwat's views, and where possible have incorporated them in our proposals for 2021/22 charges. However, given that some proposed changes to the guidance will require us to develop new methodologies we are not proposing to implement any significant changes to our charges this year. The proposals we present here therefore represent an incremental evolution of our current approach.

To allow for a considered debate on the impact of the methodological changes that we will introduce for future charging years we will engage with stakeholders in good time for 2022/23 charges.

2 General principles for 2021/22 charges

We propose to:

- retain our methodology of top down calculation based on APR data
- increase the household standard waste infrastructure length
- introduce non-household standard infrastructure lengths for water
- slightly increase the avoided leakage percentage
- retain the current fixed discount approach and create a differentiation between household and non-household properties
- incorporate an additional discount factor based on Ofwat's previous 2018 guidance.

3 Summary of questions

1	What are your views on our current Bulk Charges for NAVs document? - What would you change, add or remove?
2	We welcome views on whether our current approach delivers the objective of providing a charging framework that is transparent, simple to understand and straightforward to apply that allows NAVs to easily estimate the cost of supplying site and provides relative certainty on cost - If not, how it can be improved?
3	Do you agree that it is reasonable to continue with our current approach of using standard wholesale tariffs as the relevant start point, and assessing non-standard sites on a site-specific basis?
4	Do you agree with our proposal to retain a top-down calculation methodology for 2021/22 charges? - If not, please explain why.
5	Do you agree with our proposals for the assumptions for the standard infrastructure lengths? - If not, please explain why.
6	Do you agree that we should revise the on-site leakage value to 2.33%? - If not, please explain why.
7	Do you agree with our proposal to offer an interim uplift for 2021/22? - If not, please explain why.
8	Do you agree that refining our charging policy for surface water and highway drainage will better reflect Ofwat's guidance to companies? - If not, please explain why.
9	What are your views on the current structure of our bulk charges for NAVs?
10	Do you think that offering fixed discounts creates any disincentives for NAVs, and if so what?

For ease of response we have replicated these questions in a separate document to accompany this consultation.

4 Proposals for 2021/21 charges

Charging document

Our approach to producing our Bulk Charges for NAVs document is to present charges in a transparent and straightforward manner.

For 2021/22 we intend to expand the detail we provide in the document, and any changes that we implement following this consultation will also be incorporated, but we are interested to understand others' views on what constitutes a user-friendly publication that provides the information stakeholders require in a clear and transparent manner.

Question 1

What are your views on our current Bulk Charges for NAVs document?

- What would you change, add or remove?

Methodology for calculating bulk charges for NAVs

General principles

In producing our charges to date our objective has been to provide a framework that is transparent, simple to understand and straightforward to apply that will

- allow a NAV to easily estimate the potential cost of supplying a site, and
- provide relative certainty on cost when a variation is granted.

Question 2

We welcome views on whether our current approach delivers the objective of providing a charging framework that is transparent, simple to understand and straightforward to apply that allows NAVs to easily estimate the cost of supplying site and provides relative certainty on cost

- If not, how it can be improved?

Relevant wholesale tariffs

To date we have assumed that most properties on NAV sites in our area of supply will be households or smaller non-households, for example schools, shops and care homes, all of which are likely to qualify for our standard wholesale charges. Our NAV charges have therefore been based on household and non-household standard charges.

We have not received any site queries that have led us to consider that the approach needs to be revised. Consequently, we do not intend to make any changes to the relevant wholesale tariff on which we base our bulk charges. As standard wholesale charges for households or non-households (whichever is applicable) would apply to the majority of NAV sites, we propose to continue to base bulk charges on these tariffs.

Large users or non-standard sites

Large user charge thresholds for South West Water and Bournemouth Water supply areas are 50 megalitres (Ml) pa, and 10 Ml pa respectively. Where a site would be classed as a high user, or where a site has characteristics that are significantly different to our standard assumptions or has specific requirements, we propose to continue our policy to assess it on a site-specific basis.

Summary of proposals for 2021/22

- Continue to base bulk charges on standard tariffs for households or non-households (whichever is applicable)
- Retain the policy of assessing large user or non-standard sites on a case by case basis.

Question 3

Do you agree that it is reasonable to continue with our current approach of using standard wholesale tariffs as the relevant start point, and assessing non-standard sites on a site-specific basis?

Avoided onsite costs

As we have stated above, when producing our charges to date our objective has been transparency, clarity and simplicity.

We have employed a top-down approach using audited Annual Performance Report data and presented avoided costs¹ as fixed per-property values to be deducted from the overall wholesale cost.

To calculate avoided costs for any one charging year, we average five years' data (each indexed to the charging year) using data sourced from Tables 4D and 4P (water) and 4E and 4R (wastewater). Each of the five years' values are calculated as:

$$\text{Average avoided cost per metre} = (\text{Total avoided cost} / \text{network length})$$

APR data encompasses many of the avoided costs, including indirect costs and capital maintenance expenditure, meaning that elements do not have to be derived individually. We have understood and reflected in our Bulk Charges for NAVs document that a top down approach is likely to overstate some elements of the avoided cost, however as this supports market development it has been our preferred approach.

However, in its conclusions document and current consultation Ofwat confirms that its preferred option for avoided cost calculation is a bottom-up approach. That said, Ofwat

¹ The exception to this is the leakage adjustment where a bulk meter is utilised, where the avoided cost is applied as a percentage reduction from the wholesale volumetric charge. We discuss this element in more detail below.

acknowledges that adopting bottom-up methodologies may take time and require further engagement, and that therefore the approach may not be realised until further charging years.

We accept Ofwat's position and will commence work to start developing a bottom-up methodology, however as this will require a material change to our processes it is not feasible to implement in a short period of time. Furthermore, deferring implementation will support a fully considered and managed process and will also allow us to engage fully with stakeholders. We therefore propose to retain a top-down approach 2021/22 charges.

Question 4

Do you agree with our proposal to retain a top-down calculation methodology for 2021/22 charges?

- If not, please explain why.

Fixed discounts – standard length assumptions

For each of the rolling five years, fixed discounts are calculated as:

Avoided cost per metre x standard infrastructure length assumption

To date we have assumed standard lengths of 10.00m for water and 7.70m for wastewater and applied this assumption to all properties on NAV sites i.e. household and non-household properties. For 2021/22 charges we have reviewed these assumptions and discuss our findings below.

Water - households

Our current assumption is 10.00m.

Our review has considered standard infrastructure length characteristics across our area of operation, and within newer developments built since 2018, looking at both mean and median lengths across a number of scenarios. In total we have considered data from over 6,000 properties.

Of the data analysed, the average mean length is 10.96m, while the average median is 9.12m. An average of the two is 10.04m.

Water - non-households

Our current assumption is 10.00m.

To date we have assumed that standard infrastructure lengths for most non-households on NAV sites would be broadly similar to those of households. We have now tested this by considering properties we believe are most likely to be on a new development, namely schools and care homes. We have assumed that small shops will have similar characteristics to these.

Due to the more complex nature of the data the sample sized used is smaller than that for households, peaking at just over 900 schools and other municipal buildings extracted using Ordnance Survey information. This was compared with a smaller sample of around 100 extracts from the company's digitised data.

We found, unsurprisingly, greater variances between the mean and median values for non-households than for households. We also found variations between two samples, therefore we have calculated weighted average lengths.

The weighted average mean is 19.04m, which the weighted average median is 10.84m. The average of the two is 14.94m.

Wastewater – households and non-households

Our current assumption is 7.70m.

To review our assumptions, we considered a random sample of section 104 sewer adoptions vested since 2018, covering nearly 400 properties. The average length is 9.75m, while the median is 9.10m. The average of the two is 9.43m.

Sewer adoptions relating to non-households are infrequent in the South West Water area and so non-household-specific data is limited. Where the properties analysed are on a new development site on which there are small non-households the lengths used in the analysis will include the non-household infrastructure. If appropriate (given the required change in methodology for avoided costs), for future charging years we will look to analyse whether household and non-household lengths should be considered separately.

For 2021/22 we propose to maintain our current standard assumption of the same length of wastewater infrastructure for both households and non-households on new developments that are predominantly household, but to increase the assumed length to 9.50m.

Summary of proposals

- Maintain our assumption of 10.00m for household water
- Increase our assumption for the standard length for water infrastructure for non-households to 15.00m, while maintaining the option to consider non-standard situations on a site-specific basis

Increase the standard length for wastewater infrastructure assumption for households and non-households to 9.50m.

Question 5

Do you agree with our proposals for the assumptions for the standard infrastructure lengths?

- If not, please explain why.

Leakage

Where volumes charged are measured at the site boundary and not at customer meters, relevant start point wholesale tariffs are adjusted for on-site leakage.

Our current value of 2.32% represents 20% of the on-site leakage on a single large new development in the company area, and was calculated from a sample size of 1,100 properties.

For 2021/22 we have tested this assumption and increased the sample size to 5,400 properties across five District Metered Areas (DMAs) in four new developments. Using a consistent methodology to that used to derive the current value, the outturn estimate for on-site leakage on a new development has increased slightly to 2.33%.

We therefore propose to apply 2.33% for 2021/22.

Question 6

Do you agree that we should revise the on-site leakage value to 2.33%?

- If not, please explain why.

Additional allowance to reflect risk

Ofwat's 2018 guidance expects incumbent companies to deduct a return on on-site assets and the associated depreciation to reflect financing costs incumbents have avoided due to NAV entry. However, this was only relevant if the NAV was serving a site prior to 1 April 2018, before the rules relating to income offsets were amended to allow NAVs to operate on a level playing field. This was not relevant to South West Water and therefore WACC and depreciation elements have not been incorporated in charges to date; and the need for them is now obsolete.

In its report for Ofwat CEPA suggests that incumbents could offer an 'additional allowance' to ensure that a NAV that is equally efficient is able to earn a profit margin, and to reflect wholesale risks to which it is exposed. Ofwat responded in section 3.3 of its consultation, stating that in principle any allowance 'should reflect the operational risk experienced by NAVs to operate on-site assets which the incumbent has avoided', and has since included the option in its proposed draft guidance.

In our view CEPA's suggestion will help develop effective markets, and for that reason we support it.

CEPA proposed four potential options, while acknowledging the difficulty in establishing an appropriate level of allowance. While Ofwat has not provided views on an appropriate approach in its draft guidance, it comments in its conclusions document that a discounted cashflow approach may be appropriate.

We have reflected on how this might be best achieved in the short available timescale remaining for 2021/22 and concluded that a simple and transparent approach should be adopted.

We recognise that the methodology we propose below does not align with Ofwat's conclusions, but until further consideration can be given to developing a robust calculation methodology, we propose our approach as a short-term recognition of the draft guidance.

We therefore propose an adjustment applied as an inflator to the 2021/22 fixed discount calculated over the average rolling five years. We are currently considering options, for example South West Water's WACC plus the 0.77% PR14 uplift calculated by Ofwat in its previous 2018 guidance to companies on bulk charges for NAVs.

Question 7

Do you agree with our proposal to offer an interim uplift for 2021/22?

- If not, please explain why.

Surface water drainage and highway drainage

Our current policy is that no surface water or highway drainage charge will be applied to NAVs who make separate provision for surface water drainage. While this is clear and straightforward to apply, having considered Ofwat's Frequently asked Questions document^{vi} and its draft revised guidance we are of the view that it is not fully aligned to Ofwat's expectations.

We therefore propose that our policy should be refined to reflect site-specific circumstances, and that in future we will consider surface water and highway drainage separately, reflecting the percentages of each that are not entering SWW's network within the bulk charge.

Question 8

Do you agree that refining our charging policy for surface water and highway drainage will better reflect Ofwat's guidance to companies?

- If not, please explain why.

Structure of discounts

To date, with the exception of on-site leakage and surface water/highway drainage, we have structured bulk charges for NAVs to offer avoided costs at a fixed rate. This is on the assumption of homogeneity of properties on a NAV site, and for simplicity, clarity and certainty.

However, we are mindful that this approach could be considered a 'blunt tool'. By revising standard length assumptions for non-households we have aimed to address that non-households may be different, but we would be interested in views on the current structure in general.

Furthermore, in its recent consultation Ofwat observed that incumbents' charging frameworks could create perverse incentives to NAVs in terms of water efficiency. We do not

believe that offering fixed discounts does create these perverse incentives, but we would be interested in views on this, and also on whether fixed discounts could create any other form of disincentives to NAVs.

Question 9

What are your views on the current structure of our bulk charges for NAVs?

Question 10

Do you think that offering fixed discounts creates any disincentives for NAVs, and if so what?

5 Next steps

We welcome responses to our questions by close of business on 22 December 2020. Please send your response to NAV@southwestwater.co.uk

After this date we will review the comments received, and if we agree with any alternate proposals made and it is possible to implement them before NAV charges are published in January 2021, we may consider adopting them.

We will publish an anonymised summary of comments received and our response on our website.

ⁱ <https://www.ofwat.gov.uk/wp-content/uploads/2018/05/Bulk-charges-for-NAVs-final-guidance.pdf>

ⁱⁱ <https://www.ofwat.gov.uk/wp-content/uploads/2020/07/Consultation-on-bulk-charges-for-NAVs.pdf>

ⁱⁱⁱ <https://www.ofwat.gov.uk/wp-content/uploads/2020/07/200610-Ofwat-CEPA-NAVs-FinalReport-redacted.pdf>

^{iv} <https://www.ofwat.gov.uk/wp-content/uploads/2020/11/Bulk-charges-for-new-appointees-our-conclusions.pdf>

^v <https://www.ofwat.gov.uk/wp-content/uploads/2020/11/Bulk-charges-for-new-appointees-a-consultation-on-revising-our-guidance.pdf>

^{vi} <https://www.ofwat.gov.uk/wp-content/uploads/2020/04/Ofwat-NAV-Policy-Frequently-Asked-Questions.pdf>