

# **New Appointments and Variations (NAVs) Bulk Supply Pricing Consultation results**

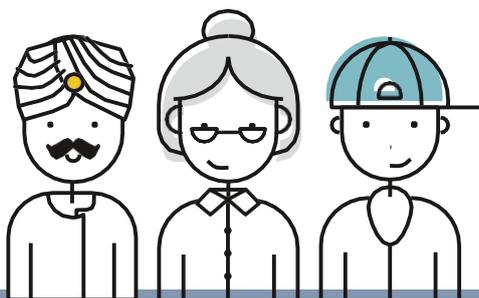
**April 2019**

# Contents

Introduction	03
<b>Get in touch with us</b>	<b>08</b>
Responses to our consultation	09
Next steps	23

# Introduction

## About the NAVs Bulk Supply Pricing Consultation



We published our New Appointments and Variations (NAVs) consultation document which sets out the updated Yorkshire Water bulk supply charging approach and tariff tool and how it aligns with the regulatory Guidance and the wider context set by Government.

The consultation was published on our website on Wednesday 20th February 2019 and closed Wednesday 13th March 2019.

Our consultation document and the bulk supply pricing model for NAVs is available for reference on our website here: <https://www.yorkshirewater.com/developers/new-appointments-and-variations/>

The New Appointments and Variations (NAVs) market supports new entrants into the wholesale water and sewerage sector and also allows incumbent water and/or sewerage companies to expand into other geographic areas.

In order to operate within the incumbent's region a NAV may choose to procure a bulk supply of water and/or wastewater services from the incumbent and the incumbent will levy bulk charges for such services. A bulk supply is the supply of water and/or sewerage services from one appointed company to another.

In May 2018 Ofwat published final guidance on bulk charges for NAVs (see Bulk charges for NAVs: final guidance, Ofwat, May 2018). Whilst this guidance did not take the form of charging rules Ofwat stated it "currently anticipate incorporating a significant proportion of the relevant elements of this guidance into future charging rules".

Ofwat further noted that "...we expect incumbent water companies to adopt best practice and consider publishing bulk charges to provide as much information as early as possible from the date of publication of this guidance".

The consultation we published on 20th February 2019 set out the updated Yorkshire Water bulk supply charging approach. The bulk charges covered by the consultation only relate to bulk supplies from Yorkshire Water to a NAV.

To provide a NAV with the charging transparency they require we also provided details of our proposed bulk supply pricing methodology.

Alongside the consultation we published a bulk charges tool (MS Excel model) to be used by NAVs to determine indicative bulk charges to enable NAVs to bid for relevant development opportunities without prior request of prices from Yorkshire Water.

We would like to thank all of our stakeholders who participated in the consultation. We will carefully consider all of the feedback we received to update our pricing tool and publish a final version later this month.

## Consultation questions

We asked 16 questions in our consultation.

Number	Question
Q1	Do you agree with the list of potentially avoidable activities and associated cost drivers? In particular, do you think any material activity, and associated avoidable cost, is missing from our list?
Q2	Do you agree that the equivalent (annual) annuity (EAA) is the best means of scaling and smoothing the different minus components in the wholesale-minus construct? If not, what other financial techniques would you suggest as alternatives and why?
Q3	Do you agree that the lifetime of the relevant asset should be used in determining the annuity, or should the timescale be limited to the duration of the bulk supply contract between Yorkshire Water and the NAV, say at 25 years?
Q4	Please provide your views to the reasonableness of our reservations about the risks of adopting historic company average costs as the primary method of estimating the long run avoidable replacement costs on a new development site?
Q5	Do you agree that the discount rate should always be equated to the company WACC, irrespective of which company's WACC is ultimately selected (the incumbent or the NAV)?
Q6	Do you think we should follow the proposed regulatory guidance on the WACC (4.74%) to set the discount rate for avoided costs? If not, what alternative cost of capital rates should we consider using?
Q7	Do you recognise the above variability in water network asset and surface water drainage asset intensity and how should this be dealt with in bulk charges?
Q8	What are your views on whether local authority rates are an avoidable cost relevant to a NAV and how they could be dealt with in bulk charges?
Q9	Do you agree with the need to reflect the key cost characteristics of each site in the minus calculation to widen the NAV market to costlier low density sites?
Q10	Are there any major disadvantages to providing greater cost reflectivity in the minus by reflecting relative network characteristics, such as network lengths, etc?

Q11	What are your views on our proposal that only the on-site operating costs and the LRACs will be deducted from the starting point?
Q12	Do you agree with our proposal to convert our water fixed charges into volumetric tariff for the calculation of the starting point? If not, what would be the reasons to provide them separately?
Q13	How do you think we should levy charges for surface water, where a NAV requires the use of our network to carry surface water from the development, and why?
Q14	Do you support our idea that the incumbent's costs should be combined with the NAV's characteristics to provide a fair estimation of the avoidable costs?
Q15	Do you support our proposal to apply estimated network losses as a percentage reduction on the overall weighted wholesale tariff which will depend on the total length of water mains at a NAV site? If not, can you please provide alternatives?
Q16	Do you think that the business overhead discount is relevant to a NAV? If yes, do you support our approach to use our retail overhead level as a proxy for a NAV overhead level?

## Summary of responses

We gathered responses to our consultation through an online form but also via email and post. We contacted via email;

- 7 NAV organisations,
- 2 trade associations representing the interests of stakeholders active in the developer services market,
- CCWater,
- Ofwat, and
- all the English water and sewerage companies (WaSCs) and water only companies (WoCs).

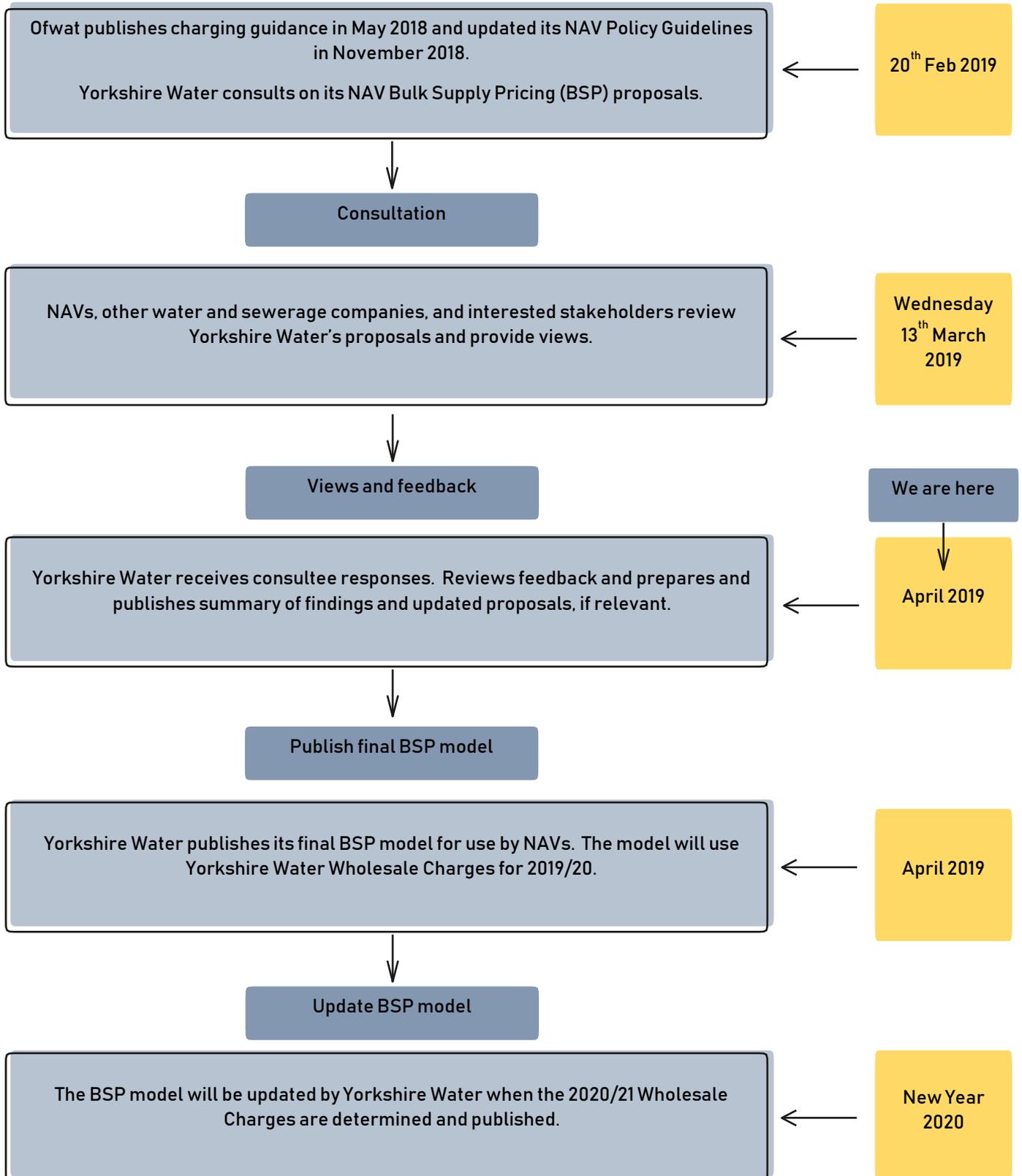
We provided these organisations a link to our consultation document, our online response form and the NAV bulk supply pricing tool.

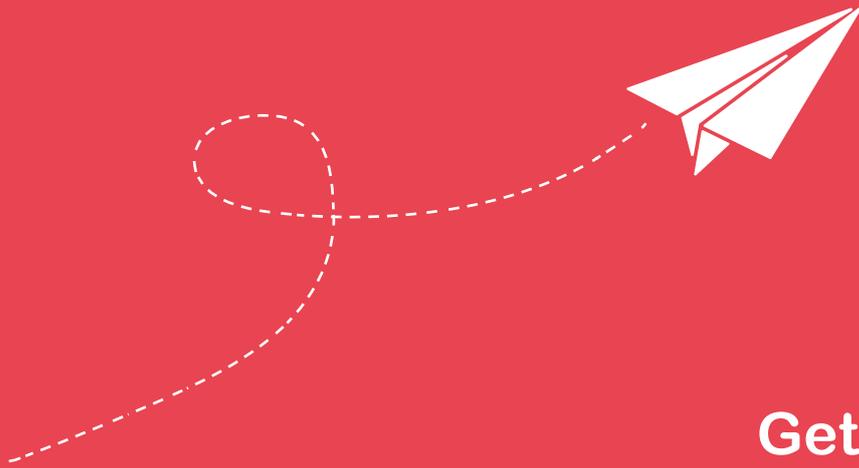
We received three responses – one from a WaSC and two from NAVs. One further NAV declined to participate advising that it has one inset appointment and does not operate in the same way as "modern day" NAVs in terms of requiring bulk supplies, and therefore has no comments to make on the consultation.

In this document we summarise the responses we received for each question and our conclusions.

# Timeline

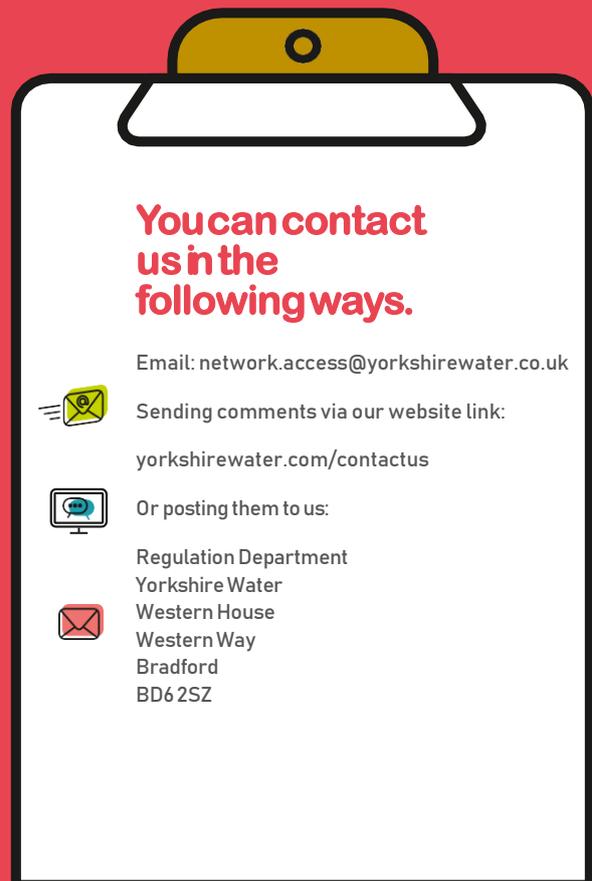
This diagram shows where we are in our consultation process and what happens next.





## Get in touch with us

Although the consultation has closed, we would still welcome your feedback on our consultation document and the NAV bulk supply pricing tool. Please send us your comments using the contact details on this page.



# Responses to our consultation

## Chapter 3.4 Identification of Avoidable Costs

**Question 1: Do you agree with the list of potentially avoidable activities and associated cost drivers? In particular, do you think any material activity, and associated avoidable cost, is missing from our list?**

In our consultation we explained the types of avoidable costs we had considered applicable to the formulation of bulk supply prices.

We referenced the Ofwat new development graphics and used this to confirm that typically the NAV will take over the responsibility for the operation, maintenance and replacement of the new assets on site. Namely; the last few metres of pipe of the water distribution and foul sewage/surface water collection network to each property on the new development.

We noted the actual length of pipe to be managed by the NAV on each network will vary from site to site, and that upon failure or at a defined renewal time the NAV will also replace the customer meter and the associated meter chamber and take over some additional responsibilities beyond the stop tap boundary (e.g. measuring water quality at the tap, replacing household supply pipes for free, managing customer communication at loss of supply events).

We also identified a more detailed list of potentially avoidable activities, and asked consultees to consider this list and advise if there were any material activities, and associated avoidable costs, missing from our list.

### Responses

We received acknowledgement that our list looked to be a full list of activities for consideration. In addition, one respondent does not believe that Yorkshire Water has explained in sufficient clarity and detail all of the areas of avoided activity that should be reflected in the NAV discount. The respondent provided its own list, as follows:

- Network Maintenance of all onsite equipment
- Emergency cover
- IT systems
- Bad debt allowances for Network costs
- General management and Health and Safety
- Corporate overheads

- Finance and HR
- Regulatory costs
- Capital maintenance
- Normal profit
- Customer support
- Water sampling and water quality
- Leakage (include site development)

Another respondent pointed out that we may not have included activities in relation to the preparation of water resource management plans and drainage water management plans in the wholesale minus approach.

### Conclusions

We have reviewed our list against responses received and believe we have covered these suitably in our existing model, and as presented in Tables 1a and 1b in our consultation document, and in consideration of overheads.

Regards to the point raised on the activities related to the preparation of water resource and drainage management plans, we will consider these within the assessment of suitable level of overheads applicable to the NAV, and how these are included alongside the avoidable costs

In our consultation we explained that the avoidable costs can have differing cost drivers for charging purposes, noting that the exact costs on each individual site will be driven by a number of site-specific factors. In addition to the cost drivers that determine the Wholesale starting point (namely mix of household and business premises on the site and their relative forecast water demands), we maintain the key cost drivers for avoidable costs to be;

- i) the length of water and sewerage pipes to be managed by the NAV; and
- ii) the number and location of meters at properties to be managed and replaced by the NAV.

## Chapter 3.6 Estimation of Avoidable Costs

**Question 2: Do you agree that the equivalent (annual) annuity (EAA) is the best means of scaling and smoothing the different minus components in the wholesale-minus construct? If not, what other financial techniques would you suggest as alternatives and why?**

**Question 3: Do you agree that the lifetime of the relevant asset should be used in determining the annuity, or should the timescale be limited to the duration of the bulk supply contract between Yorkshire Water and the NAV, say at 25 years?**

In this section of our consultation we explained our approach to the use of the equivalent (annual) annuity (EAA) to both:

- Smooth NAV operating costs that may vary over time as infrastructure renewals and operational and maintenance requirements change as underground assets deteriorate with age; and
- Provide the NAV a return on, and (annuity) depreciation of, those replacement capital costs that would, over time, otherwise be accrued to the incumbent's RCV (e.g. the second, third, etc, round of meter and meter chamber replacements).

We asked for views on the equivalent (annual) annuity (EAA) approach as the best means of scaling and smoothing the different minus components in the wholesale-minus construct, and what alternative financial techniques could be used.

We also sought views on the length of time to be used to determine the annuity, and whether the duration of the contract we as the incumbent will have with the NAV for the supply of bulk services should be the determining timeframe (and we indicated 25 years as an example). We recognised in this question that using a timescale limited to the duration of the bulk supply contract may not deliver the right discounting outcomes for NAVs, and we had not used it in the development of our pricing approach or the NAV pricing tool at this stage.

### Responses

Only the WaSC provided a response to these questions, being supportive of the EAA approach we have used. Again, the WaSC provided a response to the question of timeframe to apply to the annuity approach. They were supportive of our current approach as it is most likely to result in a level playing field compared to incumbents. It noted that incumbents have the same licence duration and would not expect to achieve full payback on long life assets within 25 years simply because of the potential for an expiry date before the relevant asset lifetime expires.

### Conclusions

As per the feedback, we will continue to use the EAA approach to scale and smooth the different minus components in the wholesale-minus price construct.

We will continue to apply the assumed asset lifetime as the basis for determining the relevant annuity for estimation of avoided costs. The use of a shorter asset life timeframe based on a specific cut off period aligned to the initial bulk supply contract end date would add significant complexity should the bulk supply contract extend or simply rollover at the point the initial contract period ends. There would need to be a further assessment of the long run costs and the asset base left to depreciate, and this approach may disadvantage the NAV.

## Chapter 3.7 Source of Avoidable Costs

**Question 4: Please provide your views to the reasonableness of our reservations about the risks of adopting historic company average costs as the primary method of estimating the long run avoidable replacement costs on a new development site?**

We discussed how we are being cautious about simply adopting historic company average costs data as our primary method for estimating long run avoidable replacement costs for new development sites. We explained our reservations under four themes;

- **Technology Shifts** - historic incumbent costs do not solely relate to the latest technology being installed/required on the new development sites, and this has a bearing on avoided costs over the long term. Historic incumbent costs can also be distorted by costs associated with the resolution of legacy water quality issues, such as early replacement of lead pipes and iron mains, or interventions that are not relevant for modern HDPE/MDPE pipe networks.
- **Mixed Asset Base** - some larger bulk supply pipes are not typically laid on-site and can be subject to more costly preventative repairs and replacement activity. Hence, we consider a simple length pro-rata of historic company average pipe management costs is not appropriate.
- **Time Value of Money** - incumbent average costs reflect the management costs of assets of mixed technologies and long average asset ages. The survival path for infrastructure assets for new developments will tend to follow a conventional S-curve, with lower annual costs in the early years following installation and higher costs in the middle of the asset's long life. Using company average maintenance costs for aged assets will essentially ignore the time value of money.
- **Planning Shifts** - Planning changes have meant that surface water drainage assets have become larger and more complex on

new developments. Furthermore, on larger developments there may be a need for storage tanks or other flow attenuation devices. This will mean that historic company cost averages may not fully reflect the additional costs of providing flow attenuation on new developments. In addition, older housing stock on the incumbents' network will be served by combined public sewers (and not separated systems as now required on new developments). This will have a further distorting impact on the applicability of historic company average maintenance costs for the sewerage service.

As such we have only used historic average company replacement cost rates in our methodology to sense check the results of our EAA approach for some specific assets.

We sought views to the reasonableness of our reservations about the risks of adopting historic company average costs as the primary method of estimating the long run avoidable replacement costs on a new development site.

### Responses

One respondent agreed with our comments on the validity of comparisons between new assets constructed on a development site and average historic costs based on a network with variable age, materials and design standards.

### Conclusions

We believe we have taken a fair approach to the source of avoidable costs, using company historic replacement costs where there is limited scope for distorting effects, and bottom up cost assessment where this is more suitable to determine the costs the incumbent would avoid should it not adopt the infrastructure at the site. We will continue to follow this approach.

## Chapters 3.9 and 3.10 Discount Rates and the Weighted Average Cost of Capital (WACC)

**Question 5: Do you agree that the discount rate should always be equated to the company WACC, irrespective of which company's WACC is ultimately selected (the incumbent or the NAV)?**

**Question 6: Do you think we should follow the proposed regulatory guidance on the WACC (4.74%) to set the discount rate for avoided costs? If not, what alternative cost of capital rates should we consider using?**

In our consultation we explained that to apply the EAA factor to assess the scale of long run avoidable costs an appropriate discount rate needs to be selected, and that the discount rate should be set to reflect the riskiness of the avoidable costs being considered.

This is typically equated to a company's weighted average cost of capital. The impact of the discount rate on the scale of the avoidable cost will depend on whether costs are incurred upfront and/or in the future.

We asked consultees if they agreed that the discount rate should always be equated to the company WACC, irrespective of which company's WACC is ultimately selected (the incumbent or the NAV). We also asked

if we should follow the proposed regulatory guidance on the WACC (4.74%) to set the discount rate for avoided costs, or what alternatives should be considered.

### Responses

Only the WaSC responded to this question, stating that this appears reasonable. It made observations on some limitations of the higher WACC, but that there is little evidence to substantiate an alternative approach.

### Conclusions

Despite our reservations, we propose to use a discount rate of 4.74% - equivalent to the WACC proposed by Ofwat. Ofwat recognises the "incumbent water companies WACC should be adjusted" to reflect two features:

- Incumbent water companies enjoy a degree of regulatory protection which is not available to a NAV, and.
- The risk of the relevant on-site activities, which it believes may be different from the risk of the incumbent water companies' overall business.

## Chapter 3.11 Accounting for Site Cost Variations

**Question 7: Do you recognise the above variability in water network asset and surface water drainage asset intensity and how should this be dealt with in bulk charges?**

In our proposed approach we noted that Ofwat recognises that “potentially each site could have its own bespoke bulk charges” as the type and scope of bulk services a NAV needs to purchase from the incumbent may vary depending on the approach the NAV adopts on the site and the local circumstances. Through the provision of our bulk supply pricing tool for NAVs to use, we are providing a method where we could cater for many of the NAV needs of each site. For example, by recognising the avoided costs differentials against the variability in the length of water main per property, the NAV determines the bulk supply price appropriate to the network density of the development site.

We explained that the variability in length of main at sites can drive site differences in future water network operating, repair and replacement expenditures. This variability will also impact on site leakage rates.

We asked if respondents recognised the variability in water network asset and surface water drainage asset intensity and asked how this should be dealt with in bulk charges?

### Responses

One respondent noted that incumbents’ charges to other classes of customers are built on regional averages and as such a degree of averaging makes charges to NAVs no different. The same respondent suggested that sites where there are unusual characteristics could be dealt with by exception. Another respondent recognised that site characteristics drive differences in costs avoided on site, and that an incumbent should

develop a cost methodology that recognises difference in avoided costs but provides certainty to a NAV in advance of what the charges will be.

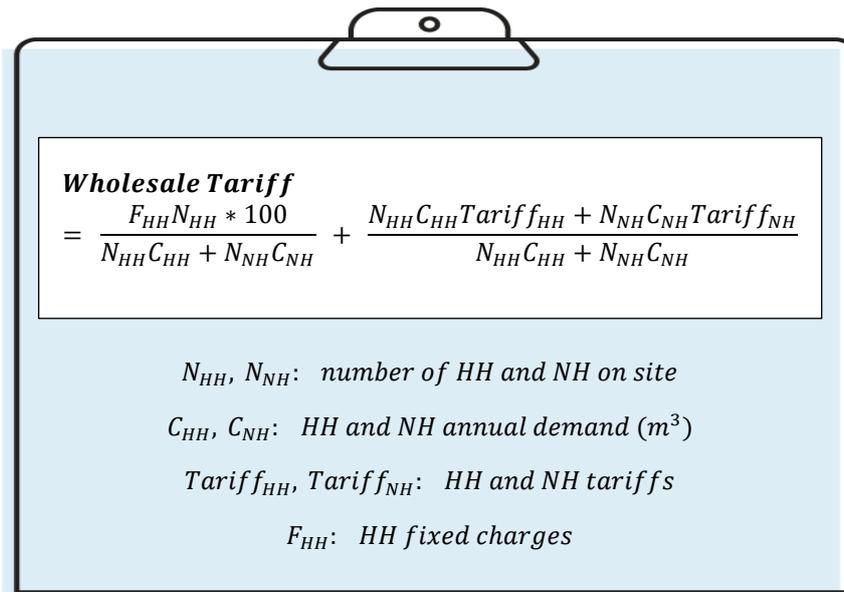
A respondent noted that “... the current Yorkshire model results in an increasing cost as site size increases. This is at odds with the existing tariff profile and no explanation has been provided as to why this is the case for a NAV customer.” And “... for the waste water NAV tariff we observed that for larger sites (greater than 3000 premises) the cost per site is equal to or more than the household wholesale tariff (a NAVs revenue cap). We also note that this is at odds with Yorkshire Waters large user waste tariff.”

### Conclusions

The key determining drivers in the pricing tool are:

- the weighted average wholesale starting point, that is affected by the mix of premises in the development between houses and commercial premises (and their relative water demands and wastewater discharges).
- The length of water mains and communication pipes for the development site
- The length of sewer network for the development site

The wholesale starting point the tool produces is a combination of the weighted average of the household and non-household volumetric tariffs (for metered supplies) and the total fixed charges converted to a volumetric component using the predicted total consumption of the site. This is expressed in the formula:



**Wholesale Tariff**

$$= \frac{F_{HH}N_{HH} * 100}{N_{HH}C_{HH} + N_{NH}C_{NH}} + \frac{N_{HH}C_{HH}Tariff_{HH} + N_{NH}C_{NH}Tariff_{NH}}{N_{HH}C_{HH} + N_{NH}C_{NH}}$$

*N<sub>HH</sub>, N<sub>NH</sub>: number of HH and NH on site*

*C<sub>HH</sub>, C<sub>NH</sub>: HH and NH annual demand (m<sup>3</sup>)*

*Tariff<sub>HH</sub>, Tariff<sub>NH</sub>: HH and NH tariffs*

*F<sub>HH</sub>: HH fixed charges*

The weighted average starting point tariff may at times appear higher than the household volumetric tariff. This is due to the addition of the fixed charge as a volumetric component, prior to any discounting for avoided costs.

The tool may well output higher bulk supply price tariffs for sites that have more premises being connected than others. This may be due to differences in the calculated avoidable costs due to differential network lengths between development sites. For transparency the tool includes worksheets that present to the NAV user the avoided cost components that contribute to the wholesale minus bulk supply price output. It can be seen that relative network length has a material influence on a number of the avoided cost components.

We have not been able to recreate the suggested scenario where our bulk supply price output from the pricing tool is higher than the weighted average wholesale tariff starting point, which

represents the effective revenue ceiling for the NAV.

It has been our historic bulk supply charging position to take account of the different site characteristics and different service requirements of NAVs when discounting for avoided costs and presenting prices. We also used a household wholesale tariff minus approach, rather than applying a large user tariff to NAVs. In this way we were already relatively well aligned to the approach Ofwat take in its guidance.

We will further consider consultees feedback as we review the BSP tool ahead of making a finalised version available to NAVs alongside our published final pricing approach.

To understand in more detail the points and concerns that NAVs may have with some of the detail of our approach and/or the tool we have provided, we will offer meetings with all NAVs consulted to discuss how our pricing approach would work effectively in practice.

## Chapter 3.11 Are Local Authority Rates Avoidable?

**Question 8: What are your views on whether local authority rates are an avoidable cost relevant to a NAV and how they could be dealt with in bulk charges?**

In February, we stated we were unsure when the local authority rates would be assessed and applied to the NAV in respect of a new development within the Yorkshire Water region. Importantly we would need to consider when assets would have accrued to the RCV of the NAV and the consequential rates payable.

We therefore sought views on how we could approach rates as an avoidable cost category and whether we could make a small explicit adjustment for future avoidable local authority rates as part of our bulk charging methodology, set against the period of the bulk supply agreement between ourselves and the NAV in question.

### Responses

Only the one respondent provided views on this question. They are also not clear what impact new developments would have on the RCV going forwards, given that developers will pay for the

new on-site assets. They proposed “To ensure a level playing field, Ofwat or the industry should collect evidence about the rating assessment made on NAV operators so that this can be allowed for within wholesale discounts.”

### Conclusions

Given the feedback we received does not provide any alternative approaches to understanding or determining how local authority rates would be established for specific developments, we remain minded to leave out an explicit avoidable cost adjustment from our bulk supply pricing tool. We would instead like to discuss with the relevant NAVs who have insets within our region the rates payable related to the developments in order to determine a mechanism to recognise this cost, and make an appropriate bespoke adjustment if necessary.

## Chapter 3.12 Asymmetric Market Risk

**Question 9: Do you agree with the need to reflect the key cost characteristics of each site in the minus calculation to widen the NAV market to costlier low density sites?**

**Question 10: Are there any major disadvantages to providing greater cost reflectivity in the minus by reflecting relative network characteristics, such as network lengths, etc?**

In our consultation document we referenced Ofwat statements around its concerns with:

- pricing being set on a bespoke basis, potentially limiting information to NAVs, and
- where tariffs are geographically averaged but where the cost of serving sites may vary geographically, NAVs “may have an incentive to serve low-cost sites, with the greatest margin, leaving incumbents to serve high-cost sites”.

To reduce the risk of such asymmetric market concentration by NAVs, Ofwat has now suggested its *“approach would base bulk supply charge on the price of wholesale water charged to retailers and then deduct the cost of serving the sites. These deductions should vary based on the cost of serving the sites.”*

Given our Competition Act duties, we have considered how we can comply with regulatory

Guidance and the associated revisions. Namely that the minus from the wholesale starting point should vary according to local avoidable costs on the site, but that incumbents should publish tariff information. Only in rare cases should the incumbent use bespoke charging arrangements.

To deliver to the above position we developed our bulk supply tariff tool to be used by NAVs as they develop bids for prospective development opportunities in the Yorkshire Water region.

We believe the tool is a straightforward approach requiring a small number of inputs by the NAV to determine the bulk supply price for water and wastewater services, that would address a range of development sites in practice.

We recognise that where the NAVs solutions will deliver capabilities further upstream of a conventional development, there would need to be bespoke elements incorporated into any final bulk supply pricing arrangement. We believe this is consistent feature across the sector against published charging arrangements.

## Responses

In response the WaSC respondent agreed that there are good grounds for some differentiation – for example, between small infill sites and larger sites where substantial infrastructure may be required. However, they think site by site differentiation undermines the predictability of charging arrangements, and that it is possible to deal with the vast bulk of sites through a simple approach and deal with more expensive sites by exception. One NAV respondent said it was unclear as to why site density should be a cost characteristic that is reflected in a NAV tariff, given it is not any of Yorkshire Waters tariffs faced by end customers.

Also, in respect of our question seeking major disadvantages of providing greater cost reflectivity to bulk supply prices, the main disadvantage raised is in the predictability of charges for the NAV.

One NAV noted a need for there to be a balance between cost reflectivity and providing cost certainty in advance of a connection application. One mechanism for this could be an actual build reconciliation post event but we recognise other mechanisms can be applied.

We also received NAV feedback welcoming our “calculator approach”. Notably “*We agree with the site-specific approach to on site assets. This will have the disadvantage of a NAV not being able to determine a site-specific charge until the nature of the development is well understood, but this will be more than compensated by their final tariff being cost reflective to their ongoing operational obligations. This will be particularly relevant to developments with onsite pumping stations adopted by the NAV.*”

The same respondent raised the hope that “*companies will apply the same logic, and CA98 concerns, to developing a zonal infrastructure charge such that a full serve NAV can compete with you fairly in the provision of water to the site and the treatment of sewage from the site.*”

## Conclusions

Our wholesale-minus construct takes into account the proposed key physical network attributes of the new development site, gives greater cost reflectivity to bulk supply prices and seeks to widen the range of development opportunities open to NAVs in practice.

We are of the view that a single regionally averaged avoided cost discount applied to a variable site-specific wholesale tariff starting point does not deliver the necessary cost reflectivity sought by Ofwat’s guidance, and that our cost reflective approach does not create a barrier for NAVs, as long as our avoided costs are assessed fairly and comprehensively.

We welcome the comments about balancing cost reflectivity with the provision of pricing information necessary to allow a NAV to bid for developments early in the process, and without routine reference to the incumbent.

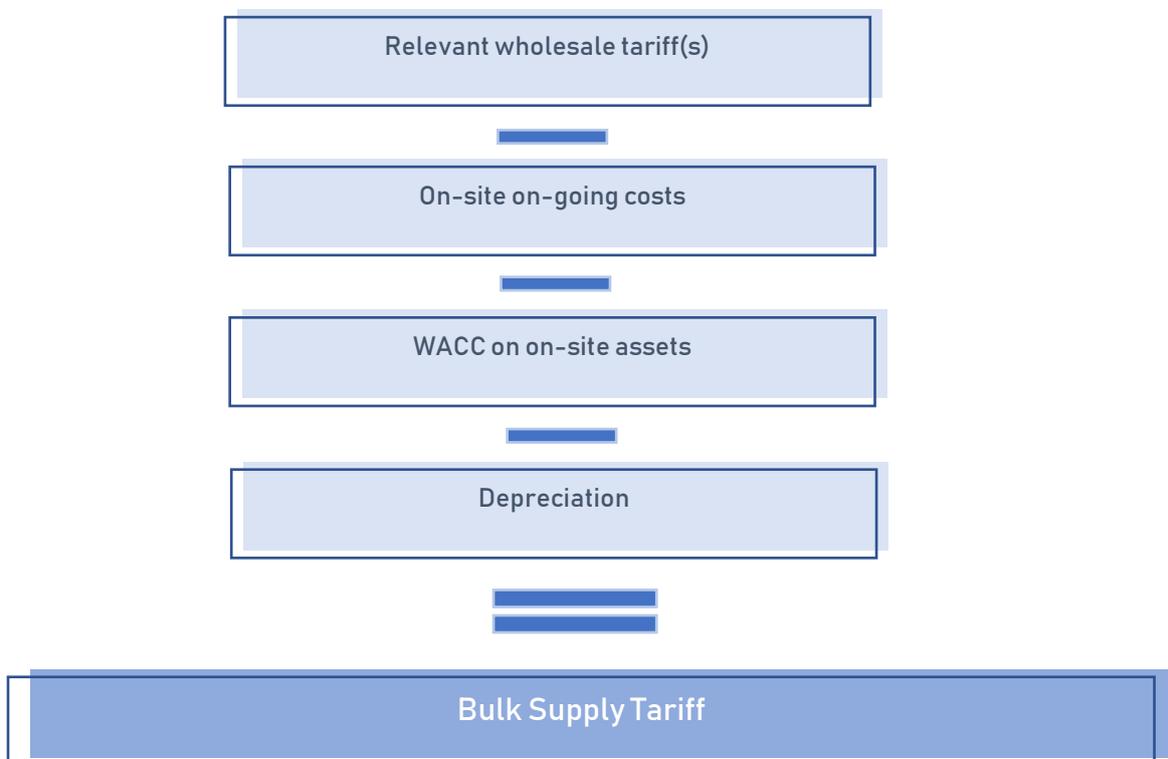
We developed our bulk supply pricing tool with the intention to allow NAVs to prepare bulk supply prices against a small number of site variable inputs, that we understand in general would be known to some reasonable degree by NAVs in advance of them submitting bids to developers.

We will engage with NAVs in the coming days to understand more about how they view the pricing tool, ahead of making any changes to in April.

## Chapter 4.1 Wholesale Minus Approach – Guidance Requirement

**Question 11: What are your views on our proposal that only the on-site operating costs and the LRACs will be deducted from the starting point?**

Over the following questions we sought more clarity around the components used in our bulk supply pricing tool. The four key components in the wholesale minus approach as identified by Ofwat are represented graphically below:



We advised in February that after careful consideration, we propose that the bulk supply pricing model should be determined by the following two groups of costs:

- The costs for operating and maintaining the on-site assets
- The long-term replacement costs for the on-site assets (Long Run Avoidable Costs)

### Responses

We only had one respondent provide a view, which was in agreement with our position.

### Conclusions

We will continue with our proposed approach to on-site and ongoing costs relevant to bulk supply pricing.

## Chapter 4.2 Wholesale tariffs – The starting point

**Question 12: Do you agree with our proposal to convert our water fixed charges into volumetric tariff for the calculation of the starting point? If not, what would be the reasons to provide them separately?**

**Question 13: How do you think we should levy charges for surface water, where a NAV requires the use of our network to carry surface water from the development, and why?**

In the consultation we confirmed the approach to set the starting point tariff for the wholesale-minus approach would be consistent with Ofwat's methodology in its guidance.

To achieve that, two sources of information are needed;

- i. Yorkshire Water's wholesale charges for the financial year 2018/19 – in-built in our pricing tool
- ii. Information on the composition of the NAV's end-customer premises and forecast usage – we expect the NAV to input this information into the pricing tool.

The wholesale charges are set in accordance with Ofwat's Wholesale Charging Rules and are reviewed every year. Therefore, bulk supply tariffs provided to NAVs will be updated annually recognising the revised weighted average wholesale tariff starting point.

We will update the pricing tool each year to the prevailing wholesale charges.

We noted that in cases where the new developments adopted by a NAV are within the defined geographical area for York Waterworks, then the starting point will be the York Waterworks wholesale tariffs (water services only).

Of particular note is our proposed treatment of fixed charge components of our wholesale tariffs. Yorkshire Water applies fixed charges for household water usage only. For simplicity, we propose to convert the household fixed charge for water services into an equivalent p/m<sup>3</sup> and

combine this with the volumetric tariff to produce the volumetric based tariff that will be the wholesale water tariff starting point for the bulk supply tariff,

For sewerage services, our surface water fixed charges are left outside this tariff calculation. We advised that if a development is to be connected to Yorkshire Water's network for surface water, we propose to charge the NAV the surface water fixed charges (as published in our Wholesale Charges) based on the property mix and numbers on a per annum basis. We envisage many NAVs will not connect developments to Yorkshire Water's network for surface water, but link directly to a local water course.

### Responses

We had one response on our proposal to convert water fixed charges into a volumetric component. The respondent does not think this is necessary – *"Converting fixed charges for the ultimate customers into an effective volumetric tariff is "looking through" the boundary of another appointee."* They then went on to explain that charging the NAV the fixed charges based on domestic properties connected and discounts would be a better way to levy this charge element, given that is how the NAV is likely to charge its end customers,

We note this approach would mean there is less risk of variability of the charges the incumbent collects from the NAV due to the lack of a link to the volumes of water consumed by the development, which will vary over time. Although it may require

a level of reconciliation with the NAV once the complete development is built.

In regard to our question on surface water charges, one respondent advised that many NAVs will choose to implement their own drainage arrangements and thereby avoid surface water drainage charges. If the NAV collects surface water drainage charges from its customers on site this improves their margins and is entirely justified. The same respondent also noted that if the NAV is charged as a single site by reference to its overall area and this may be markedly different to the charges that can it can pass on to its customers on site (most likely households). They went on to explain that depending on the

consistency between charges for households and non-households, this might mean charges to a NAV need to be set at the lesser of the two amounts to avoid imposing a margin squeeze.

One NAV respondent simply advised that that surface water charges should be seen as an additional service. Any charges levied must reflect the costs incurred by the incumbent to provide this service.

### Conclusions

We will consider the points raised in revising our bulk supply pricing tool in respect of the water fixed charges and how this is applied to NAVs and treatment of surface water charges.

## Chapter 4.3 Avoidable costs

**Question 14: Do you support our idea that the incumbent's costs should be combined with the NAV's characteristics to provide a fair estimation of the avoidable costs? Please provide comments or alternative suggestions.**

In the consultation we outlined the mechanics of the avoidable costs calculations that are used to underpin the bulk supply model in our tool. We sought views on how we use our average costs on a per metre of network or property connected basis and then combine that with the NAVs site characteristics to provide a fair estimation of the avoidable costs.

### Responses

One respondent agreed with the overall principle and that there should be some estimation of the costs that the incumbent would incur if it served

the site directly. However, one respondent stated they do not believe that this approach would satisfy a competition test.

### Conclusions

As we have explained in our consultation and earlier in this summary of response, we believe the cost reflective approach we have proposed meets both Ofwat's preferred methodology and complies with our Competition Act duties. We will undertake further internal assessment before concluding the exact nature of the avoidable costs determinate in our model when this is finalised.

## Chapter 4.5 Leakage Management and Allowance

**Question 15: Do you support our proposal to apply estimated network losses as a percentage reduction on the overall weighted wholesale tariff which will depend on the total length of water mains at a NAV site? If not, can you please provide alternatives?**

In our consultation we explained our approach covered leakage related costs in two ways - Firstly, as active leakage management expenditure, where business experts have estimated the average cost for detecting and repairing leakage in new builds. Secondly, a percentage allowance is estimated to discount for distribution losses in the network.

We then use the NAV's site density characteristics and the previously estimated annual losses to convert the value into a percentage allowance for leakage at the site. The final % discount is applied to the overall weighted wholesale tariff after the deduction of the on-site avoidable costs, to avoid double counting.

As a benchmark we reviewed the Water Resources Management Plans (WRMPs) published by many NAVs.

### Responses

One respondent offered an alternative that we should "...model the rates of leakage that the

*incumbent would incur on a new site, given the life of the assets, natural rate of rise and the type of materials used. Leakage control also needs to be factored in. This could then be taken into account within an EAA approach as the volume charged to the NAV site at the boundary will differ from amount charged to properties on site - this, and leakage control costs, would represent the cost to the NAV."*

Other respondents supported the idea of using an estimated network losses calculation but will require transparency in how this is calculated, and that they would be interested to understand how our length of main approach compares with the 4% (or thereabouts) assumed by NAVs.

### Conclusions

We will consider the points raised in reviewing our bulk supply pricing tool in respect of the leakage related costs and distribution losses and how this is applied to NAVs via the bulk supply price output.

## Chapter 4.9 Business Overhead

**Question 16: Do you think that the business overhead discount is relevant to a NAV? If yes, do you support our approach to use our retail overhead level as a proxy for a NAV overhead level?**

In our consultation we outlined that our provision in the discounts for the NAVs business overhead is based on the idea that some of the incumbent's household retail activities will notionally extend to cover the local network management or operations on the new developments. We have

estimated that the allowance for the associated household retail business costs is around 10% and it will be applied on the total avoidable costs. In effect we consider the incumbents retail overhead level is a suitable proxy for the NAVs overheads.

## Responses

One respondent agreed that overheads would normally be included within the costs that an incumbent would incur. Another agreed the NAV tariff should be discounted to reflect business overheads. However, they think that this should reflect a proportion of the wholesale cost

overheads rather than the retail cost overheads as the nature of the businesses are very different.

## Conclusions

We will consider the points raised in reviewing our bulk supply pricing tool in respect of the level of overhead discounting applied.

## General Observations and Comments

In many areas our approach has been considered constructive and follows the methodology outlined in Ofwat's guidance.

*under general competition law are met. Although YW recognise the requirement to remain compliant there is no reference to any competition tests being applied by YW and we would expect you to have completed appropriate tests when applying your final charges."*

Other feedback from the respondents included:

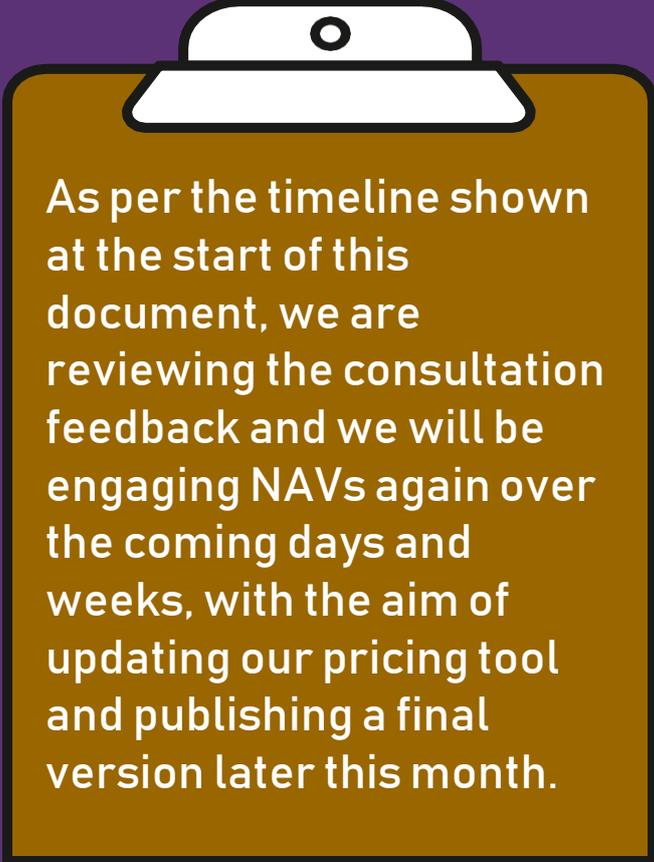
- *"... disappointed with time taken to launch this consultation following the publication of the Ofwat final guidance for bulk charges for NAVs on the 8th May 2018."*
- *"NAV charges to comply with the principles of equivalence, simplicity and transparency. Without charges clarity and certainty, a NAV is placed at a significant competitive disadvantage as they are unable to understand the long run costs that they will incur in providing services."*
- *"Immediate reaction is that an indicative pricing model makes a lot of sense. One issue that has come up recently is sharing the joy/pain of social tariffs across the bulk and on site NAV ends of the value chain. Be interesting to see if this is something you have considered."*
- *"Very concerned with the approach that YW appears to be taking in developing the level of charges should ensure the broader objectives of not inhibiting competition*

We will consider the general comments made by consultees and the subsequent discussions we will have with NAVs in the coming days in order to finalise our pricing methodology and refine our pricing tool, which may include how we present the information on avoidable costs, treatment of fixed charges, and other matters discussed earlier in this document.

We believe our approach to date based on site specific cost reflectivity is most equitable and enables more of the market to be opened commercially to NAVs.

We recognise that this method may be considered as less simplistic than some regional average pricing methods proposed in the market, and the value of this differentiation will be one subject we are keen to understand with NAVs as we reach our conclusions. We do not intend this process to be drawn out and plan to present our finalised pricing approach and model or tool as relevant, in the next few weeks.

# Next steps



As per the timeline shown at the start of this document, we are reviewing the consultation feedback and we will be engaging NAVs again over the coming days and weeks, with the aim of updating our pricing tool and publishing a final version later this month.

**YORKSHIREWATER.COM**

YorkshireWaterServicesLimited, WesternHouse, HalifaxRoad,  
Bradford, BD62SZ. Registered in England and Wales No. 2366682

