Anglian NAV Bulk Charge Consultation

Initial Comments from Albion Water Limited

Q1. Do you agree with our proposed objectives and principles for the development of our NAV tariffs? If not, please explain what alternatives you think we should consider.

We agree with your overall approach, especially in relation to openness and fairness. We agree with the need to reduce complexity and support the use of reasonably assumed metrics, as opposed to excessive calculation. In that vein we would expect "generic" assumptions to lack any bias. We understand the need for flexibility in the face of regulatory change but such changes must not be used as cover for commercial advantage.

Q2. Do you agree that we should publish the elements necessary to enable each NAV to calculate the weighted average wholesale tariff for each site, rather than a single generic price? If not, please explain what alternative you would prefer and why.

We accept that domestic and commercial properties have differing demands, so a single "mix" will result in advantages and disadvantages, potentially significant in scale. However, we do not believe that the mix is material. It is for the NAV to manage the differences as responsibility changes at the connection. We believe that the starting bulk supply price purely needs to reflect volumes, not customer mix (unless the site contains material use of an industrial nature). We will cover this aspect in more detail later.

Q3. Is it reasonable to ask NAVs to provide certain information to support both the implementation of the tariff during the applicable charging year and the retrospective "true-up"? If not, please give reasons, and provide any alternative proposals if applicable.

Based on our answer to Q2 we do not believe that there needs to be any consideration of actual mix in any year. Any sensitivity should be down to volumes where these differ, again materially, between forecast and actual. In the case of the kinds of property developments which are likely to reflect the vast majority of relevant NAV sites, there is unlikely to be dramatic differences between volumes forecast and actual consumption each year, to the extent that we believe that any retrospective changes represents unnecessary complexity and administration.

Q4. Do you agree that a downward adjustment to recorded volumes should be made for charging purposes in respect of network losses between the bulk meter at the boundary of the NAV site and the end-user customers?

We are relaxed in relation to the way in which leakage is accounted for (volume or price reduction) but remain fully supportive of Ofwat's inclusion of this aspect into any tariff structures.

Q5. Do you agree with our proposed approach to making adjustments to billed volumes to reflect potential hypothetical leakage on the NAV site? If not, please set out the alternative(s) you think should be considered.

We agree with the broad approach, and indeed the "gross" numbers. We are, however, unhappy with the arbitrary use of 25% to reflect the difference between general and on-site networks. Albion Water use a notional allowance of 4% for on-site leakage, a figure we have used in all of the calculations we have provided to Ofwat.

Q6. Do you support our proposal to make a flat percentage reduction to meter readings in respect of the network losses that would have occurred had we served NAV sites? If not, please set out what alternative approach you would prefer.

Please see answer to Q5.

Q7. If you support the flat percentage adjustment approach to address network losses, do you agree that 2.16% is a reasonable allowance? If not, what alternative figure do you propose and why?

Please see answer to Q5.

Q7 (body). Do you agree with our proposed overall approach to the assessment of on-site ongoing costs? If not, please explain why, and set out what alternative approach you wish to put forward for consideration.

We are supportive of Ofwat's suggestions, that costs need to be considered over a "lifetime". 240 years is certainly a long enough timeframe, as long as this is consistent with cyclical replacement, and does not include any material costs biased towards the later years.

Q8. Have we successfully captured all of the categories of on-site cost that need to be included in the "minus" calculation, or do you consider that we have missed anything?

We are not aware of any obvious costs not already captured here. We agree that ancillary services should be charged separately, but on a basis consistent with the costs taken out.

Q9. Do you agree that we should estimate hypothetical on-site ongoing costs with reference to the actual costs that we typically incur across our networks?

We agree with this approach, but with the consistent caveat that realistic costs need to be used. An earlier section referred to 240 years lifespans: any early benefits are quickly eroded in the grand scheme of things. References to technological improvements are unlikely to be relevant, given the nature of the costs being incurred in relation to on-site networks.

Q10. Do you support our proposal to use published data to derive the ongoing on-site cost element of NAV tariffs? If not, please explain why, and what alternative you would prefer.

We believe that using published data as the basis of deriving costs is sensible. However, in a similar vein to the assumption used for leakage, we do not recognize the pipe lengths being used here. Our direct experience is that individual connections are dramatically higher than shown here. Whilst such short lengths may be appropriate to very dense or apartment-based (primarily city-centre) construction, the majority of NAVs are based on discrete housing units. It is important to get these base figures right as the rest of the calculations are dependent on them.

The one aspect which needs further consideration is that there are dramatic differences in the network lengths between a few houses and a 10,000 home development. It may, therefore, be appropriate to have some form of "banding", certainly reflecting each order of magnitide change (e.g. 1 - 9, 10 - 99, 100 – 999 etc).

Q11. Do you agree that the ongoing on-site cost element of the tariff should be expressed on a common per-connection basis for all NAV sites? If not, what alternative would you prefer?

Subject to the above caveats we believe that a per connection basis avoids unnecessary complexity.

Q12. Do you have any comments on the indicative calculations for on-site ongoing costs for 2018/19?

Please see the answer to Q10.

Q13. Do you consider that a generic approach for capital replacement is preferable to carrying out site-by-site assessments of hypothetical future capital investment needs?

We are in favour of clear and unambiguous approaches, so are generally happy with the principle put forward, but with some consideration as to whether differing development sizes have materially differing dynamics. Again, we need to include the caveat that there should be no systematic bias in the derivation of the base costings.

Q14. Do you support our proposal to apply a common set of assumptions for the duration of capital replacement "holidays" so that this element of NAV tariffs can be the same for all sites?

We accept the principle that the capital replacement needs to take account of the fact that, in general, assets for a NAV will be new, or fairly new, to begin with. We therefore accept the principle of an initial capital replacement "holiday", but this must only relate to the initial asset's life, not subsequent ones. This is further covered in the next question.

Q15. Do you agree that it is reasonable to set the replacement holiday for each type of asset at one third of the expected asset life?

Whilst we agree with the general principle care needs to be taken to ensure not only that costs in the early stages are likely to be lower but that subsequent costs will be at an equivalent rate, essentially in perpetuity. We would therefore seek that the calculations are made on the same basis as with other assets, namely over a 240 year period. On that basis the costs of short-lived assets, such as meters, would incur essentially the same replacement cost with or without any such holiday.

The figure of one-third is again somewhat arbitrary but, as we have no basis upon which to challenge the number, any alternative would seem equally arbitrary. Therefore, given the above caveats regarding the duration of the calculation (240 years) we accept the principle.

We note that there is a potential issue with asset mix as the nature of the networks varies from site to site. We therefore need to have agreed asset base for a notional NAV as a starting point. At this stage we are unclear whether this aspect would need to be "banded" as we have suggested under Q10.

Q16. Please provide comments on our proposed methodology to give effect to the generic approach to calculating the avoided capital replacement costs, providing alternative suggestions where applicable. In particular:
a) do you agree with our identification of asset categories; is anything missing?
b) do you support our assumptions on asset lives?
c) do you have any comments on our proposed approach to unit costing and efficiency projections?
d) do you agree with our use of the NAV-specific WACC proposed by Ofwat in the Guidance for the projected return on RCV, and the wholesale WACC used by Ofwat at PR14 to convert future values into an ongoing annuity?

a) It is difficult to assess the subset of assets included within the classes proposed. An immediate reaction is that maintenance of manholes / covers represent a significant effort but it is unclear if they would be a separate asset class. We would welcome further dialogue so that a consistent understanding can be gained before making specific comments.
b) Please see our answer to 16a.
c) There is potential for discrepancy between the unit costs incurred by an incumbent (scale economies) and those for a NAV. However, as the calculations are intended to account for costs not incurred by the incumbent we feel (subject to having a realistic asset mix and to using replacement, as opposed to initial installation, costs) it is reasonable to use your costings.

We do have a fundamental issue with the efficiency arguments. Many of the raw materials involved are commodities (such as plastics) likely to incur real-terms cost inflation. Further, we doubt that efficiency savings can be compounded over the 240 years, as suggested, with a real prospect into the medium term that costs of manpower to install items will also increase in real terms. It is far too soon to be able to consider automated or robotic replacement, and periodic reviews, feeding into future tariffs, should account for any material shifts in future performance. We therefore reject the idea that any efficiency savings should be considered.

d) The approach to using differential costs of capital is divisive. Further, we would like to have access to the detailed calculations over the full 240 years (to include formulae) to gain a better understanding of the calculation methodology.

Q17. Are we right to conclude that the return on RCV and depreciation components of the "minus" calculation in the methodology set out in the Guidance are only relevant for the bulk charges for NAVs appointed before 1st April 2018 so far as up-front investment is concerned (as distinct from future capital replacement)? If you have a different view, please provide details of other NAVs to which you think these elements are applicable.

We have no relevant NAVs in the Anglian area but agree with the principle that changes should only apply going forward.

Q18. Do you agree with our proposed approach to:
a) the definition of the incremental RCV on which a return would have been earned;
b) the calculation of the income offset?
In each case, please indicate where you disagree and what alternative approach(es) you would propose.

As this applies to "Legacy NAVs" we have no comment.

Q19. Do you agree with our analysis of the derivation of "avoided rates costs"? If not, please explain what alternative approach you think is appropriate.

The consultation makes it clear that rates are paid on profits. It is difficult to see that there would have been no profitability associated with the supplies had the incumbent been supplying the relevant development. On that basis there is likely to be an element of rates avoided in supplying the NAV so this should be accounted for within the Bulk Supply tariff.

Q20. What are your views on our proposed approach to the depreciation policy to be applied to the net capex that would have been added to our RCV at the time a site was developed, including the asset life assumption?

As this applies to "Legacy NAVs" we have no comment.

Q21. Do you have any comments on the "rolling RCV" calculations that we have set out, and the way that we propose to derive the return on capital, depreciation, and rates elements of the "minus"?

As this applies to "Legacy NAVs" we have no comment.

Q22. What are your views on the proposal to apply a retrospective "true-up" as part of the application of NAV tariffs so that the effective price paid by the NAVs at each site is correct?

Under Q2 we made the comment that the mix should be irrelevant, with volumes (on a banded basis) being the main driver. We therefore believe that any retrospective "true up" should be unnecessary.

Q23. Do you agree that we should aim to set provisional tariffs that are based on the best available forecasts for the relevant Charging Year?

As previously stated we do not believe in spurious accuracy. As long as the assumptions are reasonable, realistic, open and supported with evidence then we are happy to work on that basis.

Q24. Do you have any comments on the proposed process for calculating provisional NAV tariffs in advance of the relevant Charging Year, and carrying out the "true-up" after the end of the Charging Year?

Following on from our comments on the need for openness and simplicity we are against any additional work in having to carry out retrospective exercises, other than in the event of manifest error or deliberate manipulation of any assumptions.

Q25. Do you have any comments on our proposed approach to dealing with future regulatory and other changes? Please indicate if there are any additional points you think we should consider.

As NAVs we accept that we are fundamentally "price takers". On that basis we accept the need to follow any regulatory changes, whether they are direct on us or indirect through tariffs. The one point we must make is that it would be wholly unacceptable for any regulatory gaming to take place resulting in any form of margin squeeze.

Q26. Do you agree that new NAV tariffs should be backdated to 8th May 2018 for existing NAVs? If not, please explain what alternative approach you propose.

As this applies to "Legacy NAVs" we have no comment.