



**Draft determination of bulk supply prices charged by
Anglian Water to Independent Water Networks Limited
for the supply of potable water and the discharge
of wastewater to the Priors Hall site, in Corby
Northamptonshire, under sections 40A and 110A
of the Water Industry Act 1991**

13 February 2014

About this document

This is a consultation on Ofwat's draft determination of the relevant price charged by Anglian Water Services Limited (**Anglian Water**) to Independent Water Networks Limited (**IWN**) for the bulk supply of potable water and the bulk discharge of wastewater in order for IWN to serve the Priors Hall new development site, in Corby Northamptonshire, under sections 40A and 110A of the Water Industry Act 1991.

This is the first instance in which we have applied our published three-step [framework](#) for resolving bulk pricing disputes. Consequently, we are inviting interested stakeholders to provide their view on how we have implemented our framework in this draft determination.

A bulk supply is the supply of water or sewerage (wastewater) services from one appointed water company to another appointed company or a large retail user. Companies can draw up a contract between them (a 'bulk supply agreement') that sets out the terms and conditions of a bulk supply, including the price. If companies fail to reach agreement, they can ask us to make a decision (a 'determination') on the terms of the bulk supply agreement.

Ofwat has powers under sections 40, 40A, 56 and 110A of the Water Industry Act 1991 (as amended) to determine bulk supply prices and other contracted terms of bulk supply agreements.

Over the past year, we have taken steps to increase the transparency of our casework, including launching our live case [register](#). In making decisions on strategic casework matters, we want to be as transparent as we can with all stakeholders about how we have reached our conclusions. This document describes our investigation and explains how we have reached our determination of the relevant bulk prices in this case.

In particular, we have previously sought specific information from stakeholders to inform our determination of this matter. This included the factors that could affect the cost of serving a housing development (through a bulk supply to a new appointee) versus a large user of similar annual consumption/discharge. We welcome the views of interested stakeholders on this aspect of our determination.

We will consider carefully the responses we receive to this consultation before we publish our final determination.

This document sets out the information on which we based our decision. However, in a small number of instances we have excluded information that is commercially sensitive.

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Executive summary

On 17 December 2008, we received a determination request from Anglian Water to vary the bulk supply price (**BSP**) terms to be applied in respect of the provision of bulk supplies of water and bulk sewerage services from Anglian Water to IWN. IWN requires these services in order to serve customers at the Priors Hall new development site located in Corby in Northamptonshire.

Anglian Water and IWN are in dispute about the price that IWN should pay to Anglian Water for the bulk services outlined above. Both parties have signed bulk supply and bulk discharge agreements under which Anglian Water is charging IWN its relevant published large user tariff (**LUT**) for the provision of bulk services.

We have recently published a framework for resolving pricing disputes involving bulk supplies, which we have applied in this determination. Using this framework, we have considered whether the price in dispute (in this case, Anglian Water's LUT):

- a. is appropriate given the geographic nature of supply;
- b. would give rise to competition concerns; or
- c. would give rise to efficiency concerns.

In summary, after applying the tests above we have concluded that there is no compelling evidence for us to deviate from the LUT as the BSP in this case. In addition, we have not seen any evidence in this case to demonstrate that there is a material difference in the costs of providing bulk services to a large user customer as opposed to a new appointee serving primarily household customers.

Based on the specific facts of this case, we therefore conclude that the LUT, at any given point in time, is the appropriate BSP to be used in the bulk supply and bulk discharge agreements between the Anglian Water and IWN for the Priors Hall site.

Responses to this consultation will help to inform our final determination.

Consultation questions

We welcome views from interested stakeholders on the issues set out in our draft determination and specifically on the questions below.

Q1 Do you have any comments on how we have applied our published framework for resolving bulk pricing disputes in this determination?

Q2 Do you have any views on the different factors (and materiality of those factors) which may affect the costs of providing bulk water and sewerage services to large users versus new appointees who serve household customers? Please provide clear evidence to support your response to this question.

Responding to this consultation

We welcome your responses to this consultation by **13 March 2014**.

You can email your responses to BSPconsultation@ofwat.gsi.gov.uk or post them to:

Harpreet Atwal
Bulk supply price consultation
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Next steps

The consultation closes on **13 March 2014**. Once we have considered responses received, we will make any changes we deem necessary before publishing our final determination.

1. Introduction

- 1.1 The Water Services Regulation Authority (**Ofwat**) received an application from Anglian Water on 17 December 2008 requesting us to vary the BSP terms to be applied in respect of bulk supplies of water and bulk sewerage services to be made by Anglian Water to IWN in relation to the Priors Hall site in Corby, Northamptonshire, under sections 40A and 110A of the Water Industry Act 1991 (the **Act**). As part of its application, Anglian Water said it considered the published LUT to be inappropriate for the purposes of setting the bulk supply prices to be used in agreements with potential new appointees.
- 1.2 We have considered this application and accepted it as:
- a. it appears to us that it is necessary or expedient for the purpose of ensuring the efficient use of water resources, or the efficient supply of water, to vary the bulk agreements in place between Anglian Water and IWN (together, **the Parties**); and
 - b. we are satisfied that this cannot be achieved by agreement between the Parties.
- 1.3 New appointments and variations of appointments are currently the primary vehicle with which competitive pressure can be applied to existing appointees. We refer to companies that have been granted a new appointment as ‘new appointees’.
- 1.4 We have now fully considered the information received from the Parties and other relevant information. This document sets out our draft determination of the BSP terms of the bulk supply and bulk discharge agreements to be applied by the parties, and adopts the following structure.
- a. The applicable legal framework (chapter 2).
 - b. The factual background (chapter 3).
 - c. Ofwat’s draft determination (chapter 4).
- 1.5 Appendix 1 to this draft determination sets out a chronology of the requests for information (**RFIs**) we have issued as part our investigation and the responses we received.

- 1.6 Appendix 2 sets out details of the cost of capital analysis we have used as part of our consideration of competition concerns in this determination.
- 1.7 Appendix 3 sets out a summary of the responses we received to our request for information sent to relevant stakeholders in July 2012, to inform our analysis in this case.
- 1.8 Appendix 4 sets out a list of the documents that are relevant to this determination.
- 1.9 While this draft determination does not seek to deal explicitly with each individual issue raised in the correspondence we have received, we have considered the relevant information necessary to make our draft determination.

2. Applicable legal framework

- 2.1 Section 40 of the Act gives Ofwat the power to require a bulk supply of water between a supplier and an applicant for that supply on such terms and conditions and for such period as Ofwat determines. A supplier is the water undertaker specified in a bulk supply application. Our determination takes effect as an agreement between the supplier and the applicant. Section 40A of the Act gives Ofwat the power to vary or terminate a bulk supply agreement.
- 2.2 Section 40A of the Act provides that:
- i. any party to a bulk supply agreement may apply to Ofwat to vary the agreement or terminate it (section 40A(1) of the Act);
 - ii. Ofwat may by order vary or terminate the agreement if –
 - a) it appears to Ofwat that it is necessary or expedient for the purpose of securing the efficient use of water resources, or the efficient supply of water, to vary the agreement or to terminate it; and
 - b) Ofwat is satisfied that cannot be achieved by agreement between the parties (sections 40A(1) and (2) of the Act);
 - iii. variation, for the purposes of section 40A of the Act, means varying the period for which the supply of water is to be given or varying any of the terms and conditions on which that supply is to be given (section 40A(2) of the Act).
- 2.3 Section 110A of the Act is an equivalent (although not identical) provision to sections 40 and 40A of the Act, except that it deals with sewerage services rather than the supply of water. It provides that:
- i. Ofwat may by order require an established undertaker to allow a main connection into its sewerage system;
 - ii. such an order takes effect as an agreement between the established undertaker and the applicant for the connection;
 - iii. an order made by Ofwat (requiring the undertaker to allow a main connection into its sewerage system) may be varied or revoked by a subsequent order made by Ofwat on the application of either party to the agreement, as well as by agreement between the parties (section 110A(5) of the Act).

- 2.4 We must consult the Environment Agency before making an order under either sections 40A or 110A of the Act (sections 40A(3) and 110A(6) of the Act) – we will do so at the same time we consult the Parties on this draft determination.
- 2.5 In exercising its functions under both sections 40A and 110A of the Act, Ofwat must have regard to the desirability of:
- i. facilitating effective competition within the water and sewerage industries;
 - ii. the existing undertaker's (in the case of sewerage) or the supplier's (in the case of water) recovering the expenses of complying with their obligations by virtue of sections 40A and 110A of the Act and securing a reasonable return on their capital;
 - iii. the existing undertaker's or the supplier's being able to meet their existing obligations, and likely future obligations, to supply water and to provide sewerage services without having to incur unreasonable expenditure in carrying out works; and
 - iv. not putting at risk the ability of the existing undertaker or the supplier to meet their existing obligations, or likely future obligations, to supply water or provide sewerage services (sections 40A(7) and (8) and 110A of the Act).
- 2.6 Under sections 40A(5) and (6) of the Act, an order varying a bulk supply agreement may require the payment of compensation by any party, and any such requirement is enforceable by Ofwat under section 18 of the Act. There is no equivalent provision in section 110A of the Act.

3. Factual background

(A) The Parties

- 3.1 Anglian Water is a water and sewerage undertaker appointed under the Act. It provides water to around 4.4 million consumers and sewerage services to around 6 million consumers in the East of England and Hartlepool areas.
- 3.2 IWN was granted a new appointment in October 2007 for a housing development at Long Croft Road near Corby. New appointments and variations allow one company to replace another as the statutory supplier for a specific geographic area. Since then, we have varied IWN's area of appointment so it can serve a further nine sites for water and/or sewerage. A full list of these sites is set out below.
- a. Priors Hall in Anglian Water's water and sewerage area (January 2008).
 - b. Great Billing Way (water only) in Anglian Water's area (September 2008).
 - c. Brooklands in Anglian Water's water and sewerage area (December 2009).
 - d. The Bridge in Thames Water's water and sewerage area (February 2010).
 - e. Berryfields in Thames Water's water and sewerage area (June 2010).
 - f. King's Cross in Thames Water's water and sewerage area (June 2010).
 - g. Oakham (water only) in Severn Trent Water's area (August 2012).
 - h. Additional land at Berryfields in Thames Water's water and sewerage area (January 2013).

- i. Greenwich Millennium Village in Thames Water's water and sewerage area (November 2013).

(B) The services

- 3.3 IWN purchases the supply of potable water and the discharge of wastewater services from Anglian Water in order to provide water and sewerage services to the Priors Hall development (which will consist of approximately 5,100 homes and 51 business units when completed).
- 3.4 Anglian Water provides water and sewerage discharge services to IWN in accordance with the terms of bulk supply and bulk discharge agreements between the Parties. These agreements were signed in 2008; however, they only covered a connection to enable IWN to serve an Academy on the site and the first phase of the residential development (up to 600 houses).
- 3.5 Both the bulk supply and bulk discharge agreements signed in 2008 by the Parties were due to be replaced with agreements to govern the site as a whole. Negotiations between the parties in respect of the new agreements took place in 2011; however, it remains unclear whether these new agreements were ever signed and put in place.

(C) Chronology of key events

- 3.6 On 2 September 2008, IWN submitted a formal application for a determination under sections 40 and 110A of the Act in relation to the terms of its bulk supply and bulk discharge agreements with Anglian Water, for the Priors Hall development. IWN's application requested that Ofwat make a determination on terms relating to the ownership of assets and minimum supply pressure.
- 3.7 On 3 December 2008, we forwarded IWN's application for a determination to Anglian Water for comment.
- 3.8 On 17 December 2008, Anglian Water provided a response to us on IWN's application for a determination. Anglian Water also submitted its own application for a determination under sections 40A and 110A of the Act, in respect of the BSP terms of the agreements for the Priors Hall (and other new appointment) site(s).

- 3.9 On 7 April 2009, we requested further information from the Parties in respect of the determination applications submitted by each company. Anglian Water responded on 5 May 2009. IWN responded on 12 May 2009.
- 3.10 On 10 August 2009, we wrote to both Anglian Water and IWN confirming that we would deal with the applications received under sections 40A and 110A of the Act in relation to the Priors Hall site (and not other sites). We confirmed that we would deal only with the Priors Hall site and would only deal with price terms (and not the non-price terms) for the existing agreements in place between the Parties.
- 3.11 After some further exchanges of correspondence (including IWN's response of 28 August 2009 to Anglian Water's determination request of 17 December 2008), we wrote to the Parties on 10 November 2010 confirming that we would proceed on the basis of our letter to the Parties dated 10 August 2009. We sought confirmation from the Parties that they accepted this approach. Both Parties confirmed that they accepted our proposed approach (Anglian Water in a letter to us on 19 November 2010 and IWN in an email to us on 22 November 2010). Following confirmation from the Parties, we opened a case to determine the BSP terms only for the Priors Hall site.
- 3.12 During the course of our investigation we have issued a number of requests for information (RFIs) to the Parties. We also issued a RFI to relevant stakeholders to inform our analysis. Details of our information requests and the responses we received are set out in appendix 1.

4. Our draft determination

- 4.1 This chapter sets out our draft determination of the BSP terms between the Parties in respect of the bulk supply of water and bulk sewerage services at the Priors Hall site.
- 4.2 Our conclusions in this chapter on the BSP apply both to the bulk supply of potable water and the provision of bulk sewerage services by Anglian Water to IWN.
- 4.3 The structure of this chapter is as follows.
- Part A sets out the views of the Parties on what the approach to setting the BSP should be in this case.
 - Part B describes the approach we have followed to make our draft determination.
 - Part C sets out how we have applied our published framework for resolving pricing disputes in reaching our draft determination of this matter.
 - Part D sets out our summary of the views of relevant stakeholders on the differences in supplying large users and new appointees serving household customers.
 - Part E sets out our conclusion and our draft determination of this matter.

(A) Views of the Parties

Anglian Water

- 4.4 In response to first our RFI, which we issued to Anglian Water on 18 February 2011, we asked Anglian Water what it considered to be the appropriate BSP for providing potable water and discharge sewerage services at the Priors Hall site (question 6 in the RFI). In its response, sent to us on 18 March 2011, Anglian Water stated the following.

“Anglian Water strongly believes that an approach to bulk pricing based on retail minus is the most appropriate. This approach offers a number of benefits because it:

- incentivises efficient entry by ensuring entrants cannot make profits purely through arbitrage
- maintains the same balance of payments between current customers and new customers for the assets needed to serve new developments as dictated by law
- protects the generality of customers from increased retail prices. In the case of the Brookland inset Ofwat calculated the potential effect on our existing customers as approximately 17p per customer per year. The cumulative effect of multiple sites will make this much larger
- prevents discrimination by achieving a level financial playing field between the statutory requisition route faced by developers and the inset route
- is compliant with Competition Law because it ensures against margin squeeze by ensuring that an equally efficient competitor can afford to make the same offer to a developer as that made by Anglian Water
- offers cost reflectivity yet preserves regional average pricing by using the domestic retail tariff as a starting point but takes account of site specific costs avoided.”

4.5 Anglian Water also wrote to us on 1 April 2011 explaining why, in its opinion, the LUT is not an appropriate basis for setting the BSP for the Priors Hall site. The reasons set out by Anglian water in its letter are summarised below.

Potable water supply

- a. **Water quality.** Anglian Water considered the water quality requirements of large users, in general, to be very different from those of household customers, including those in areas served by new appointees. Anglian Water thus considered that there should be a different price charged. As far as Priors Hall is concerned, however, Anglian Water noted the fact that its water needs are essentially 100% potable, whereas the corresponding percentage for Anglian Water’s large user customers, on average, is likely to be substantially less than this. Anglian Water suggested that this provides a further reason why, as a matter of principle, the LUT is not an appropriate basis for a BSP.

- b. **Peak demand of new appointees relative to large users.** Anglian Water claimed that new appointees supplying households have higher 'peaks' than large users. It considered that the more 'peaky' the demands of a customer class, the greater the share of costs that is allocated to it. It has stated that this is because, with primarily domestic characteristics, the demand of the new appointee customer at the peak day would be expected to be high in relation to its average demand, whereas for large users whose demand tends to be fairly steady the peak to average ratio is close to unity.
- c. **Credit risks of new appointees.** At the time, Anglian Water stated that the rate of return that is built into the LUT would not be an appropriate basis for a BSP to IWN. It says that the risk characteristics of its large user customers vary and would in general be regarded as very low risk. Anglian Water argues that in contrast, IWN represented a very bad credit risk by comparison, and therefore the rate of return should be higher. However, Anglian Water had not considered what this rate of return could be.
- d. **Customer service costs.** Anglian Water has also suggested that the customer services cost element of the LUT is unlikely to provide an appropriate basis for charging IWN. It highlighted that whereas Anglian Water's large user commercial relationships can be dealt with on a 'business-as-usual' basis, the relationship with IWN, both in terms of dealing with set-up issues and on-going issues under the bulk supply agreement is both more intensive and demands far greater involvement of senior management time than would be the case for an equivalent large user. As a consequence, Anglian Water considered that the costs of providing customer services to IWN substantially exceed those for a large user of similar size.

Sewerage discharge services

- 4.6 Anglian Water says that the differential water quality factor described above does not apply on the wastewater side, because customers can elect to discharge different effluent strengths, which are then reflected in the costs Anglian Water incurs. The differential customer services costs and the differential rate of return, apply equally to the wastewater side according to Anglian Water.

4.7 Based on a comparison of the average costs of supplying large users with the average cost of supplying new appointees, Anglian Water concluded, as for the water service, that the LUT would not be a good basis for a BSP for the Priors Hall site and noted that, if anything, the costs of serving IWN at the site may be higher than for the region as a whole.

IWN

4.8 We issued our first RFI to IWN on 18 February 2011, where we asked IWN what it considered the appropriate BSP should be. A summary of IWN's response is set out below (our emphasis added).

“...Ofwat will be aware that it is very difficult for IWN to precisely quantify Anglian's bulk supply costs so that it can specify what price terms should have been used given that it does not have access to the relevant cost information. In the absence of such cost information we contend **that Anglian should use whatever price would be established by applying the principles in OFT Guidelines** “Assessment of Conduct” explained below.

“Whatever price is established must allow Anglian's downstream business (and, by extension, any new entrant which competes with Anglian's downstream business) to (at least) recover the following (non-exhaustive) costs¹....

“If Anglian does not offer a price consistent with the OFT Guidelines then Ofwat must be alert to the possibilities that a margin squeeze will be taking place which is actionable under sectoral powers and also under Chapter II of the CA98....

¹ The following cost categories were listed.

- Network maintenance.
- Emergency cover.
- IT systems.
- General management.
- Health and safety.
- Finance and HR.
- Regulatory.
- Capital maintenance.
- Bulk charges.
- Normal profit.

“...note that **the case law mentioned ... when properly interpreted, does not support a Retail minus or Efficiency Component Pricing approach** – and as such we believe that whilst it is a useful exercise to establish which costs are displaced by a new entrant **this must nevertheless act only as a starting point for the analysis.**”

(B) Our analytical approach

Approach to gathering information

- 4.9 We issued RFIs to the Parties between February 2011 and June 2013 to obtain information to inform our determination of this matter.
- 4.10 In addition to requesting information from the Parties, we also issued RFIs to all existing appointees that have been replaced by new appointees in parts of their areas and all new appointees themselves. We did this to better understand the costs associated with the provision of a bulk supply of water and bulk discharge services to a new appointee serving a development consisting primarily of residential properties. A summary of these responses is included in appendix 3 to this document.

Information from RFIs

- 4.11 Between February 2011 and June 2013, we have undertaken an analysis of the following key information received from the Parties.
- a. Understanding the specifics of the Priors Hall site, including:
 - i. services provided at the site;
 - ii. likely costs incurred by both Anglian Water and IWN in providing their respective services;
 - iii. likely volume of water delivered and consumed at different stages of site completion; and
 - iv. assets involved in supplying the site.
 - b. Analysis of Anglian Water’s views on the appropriateness of using the LUT as a basis for the BSP for the Priors Hall site.
 - c. Analysis of the Parties’ submissions on what they think should be the BSP at the Priors Hall site.

d. Analysis of Anglian Water's approach to setting its LUT.

- 4.12 We requested Anglian Water in June 2012 to send information on how Anglian Water sets its LUT. Anglian Water, in response, submitted two cost allocation models (for water and wastewater respectively). It used a hypothetical new appointee customer in those models to illustrate differences between supplying large users and new appointees. Anglian Water stated that these models do not calculate the LUT but rather inform the setting of the LUT. We do not consider that Anglian Water has adequately explained to us how it set its LUT.
- 4.13 We issued another information request (our third information request) in March 2013 to Anglian Water with clarification questions on both the models, including another request to Anglian Water to explain how it constructs its LUT. Following meetings with Anglian Water on 22 and 27 February 2013, and after issuing our final RFI for clarifications on previous responses, Anglian Water provided a response on how it sets the LUT. After reviewing the information we have received from Anglian Water, we have concluded that while Anglian Water's cost allocation models are informative as to how it models peak demand effects on cost they do not arrive at a final LUT price (although the outputs from Anglian Water's models are close to its LUT).
- 4.14 While Anglian Water responded to our RFI questions on its LUT we consider that it was unable to clearly demonstrate to us how it had set its LUT. Therefore, we have not been able to make any firm judgements about the cost reflectivity of the LUT although we have no evidence that the LUT is not cost-reflective. However, on the basis of the information we collected in this case we concluded that it was appropriate to proceed with our investigation using the LUT as the starting point to see if it would cause material adverse effects using our framework for resolving pricing disputes.

Our framework for resolving pricing disputes involving bulk supplies

- 4.15 It is important to note that while we are currently determining charges to resolve various pricing disputes (such as for the Priors Hall site), there is also work being undertaken in relation to developing guidance and rules applicable to future charges. The Water Bill² provides for Defra and Welsh Ministers to issue guidance on charging, and Ofwat to issue charging rules (having regard to this guidance) for charges imposed by companies – including bulk supplies, connection charges and charges schemes (section 16 of the Bill).
- 4.16 This might result in a situation where charging terms for current determinations are set on a different basis from those set for customers following the finalisation of the guidance and rules on charging. So, it is important that the framework we use to make determinations to resolve pricing disputes now is clear and consistent, but also flexible to future changes.
- 4.17 In order to ensure no inconsistency arises, we have published a framework for resolving pricing disputes involving bulk supplies, which sets out how we propose to minimise inconsistencies with future approaches to pricing³. Throughout the remainder of this document we refer to this as '**the framework**'. This sets out:
- a. the effect of adopting different approaches to setting charges for different customers;
 - b. our objective in resolving pricing disputes;
 - c. the approach we will take for assessing costs to resolve pricing disputes now; and
 - d. how we will minimise any potential inconsistencies with our potential future approach to charging.

² Introduced into Parliament on 27 June 2013 – see <http://services.parliament.uk/bills/2013-14/water.html>

³ http://www.ofwat.gov.uk/regulating/casework/investigation/pap_pos_bulksupplydispute

(C) Applying the framework

- 4.18 This section sets out how we have applied the framework to:
- a. assess costs at the Priors Hall site; and
 - b. ensure there is a mechanism to minimise any potential inconsistencies with our potential future approach to charging.
- 4.19 In applying the framework, we have considered the arguments and evidence collected between February 2011 and June 2013 from Anglian Water, IWN and other relevant stakeholders.

Assessment of costs at the Priors Hall site

- 4.20 In our framework for resolving pricing disputes involving bulk supplies we state that in terms of assessing costs, we consider that the best approach for resolving current bulk supply pricing disputes is to use the price being disputed as a starting point for our investigation. We term this the ‘business-as-usual’ approach. This business-as-usual approach will typically, but not necessarily, involve setting charges on the basis of relevant average accounting costs (AAC). This is because average accounting cost has been, to date, the mode of cost assessment in the water sector.
- 4.21 We will only depart from this approach where our testing shows that this approach would cause material adverse effects. In particular, we will examine whether the price being disputed:
- a. is appropriate given the geographic nature of supply;
 - b. would give rise to competition concerns; or
 - c. would give rise to efficiency concerns.
- 4.22 In this determination we have used the price being disputed at the Priors Hall site, as the starting point for our investigation. The price being disputed is Anglian Water’s published LUT.

Test 1: Geographic nature of supply

- 4.23 This test determines whether a bulk supply price based on local costs would be more appropriate than those based on average accounting costs. For the purpose of the Priors Hall site we considered two broad cost categories. These were customer-specific costs and common costs. Customer-specific cost are defined in this context as those incurred by Anglian Water to solely supply IWN at the Priors Hall site. Common costs are defined as those incurred by Anglian Water for supplying its whole network.
- 4.24 Anglian Water submitted a description of the supply system at the Priors Hall site in its response to our first RFI of 18 February 2011. The Priors Hall site is located close to Corby in Northamptonshire. The appointment of IWN was granted on the basis that IWN would eventually serve about 5,100 domestic premises and 51 businesses at Priors Hall. The domestic and business premises were to be constructed over a 15-year period.
- 4.25 Priors Hall is supplied with potable water from the Ruthamford Network, which is an integrated water resources and supply system. Raw water is abstracted from the River Nene at Wansford and the River Welland at Tinwell. Using Rutland Water Reservoir, the water is sent to Wing and Morcott treatment plants. Water from those treatment plants flows through the strategic network, specifically the storage at Beanfield, to be then prepared for distribution. After Beanfield, the water travels through the Corby distribution network to the points of connection for Priors Hall. Water from the Wing and Morcott treatment plants is also used to supply the major conurbations of Bedford, Milton Keynes, Northampton and Peterborough plus various towns and rural areas, including Corby and Daventry. For sewerage, Priors Hall will drain in to Corby Sewage Treatment works.
- 4.26 Anglian Water has stated that all assets used to supply the Priors Hall site are also used to supply other water and sewerage customers – other than the existing and proposed metered connections between Anglian Water’s network and IWN’s network. This is the case for both the supply of potable water and the discharge of wastewater.

- 4.27 In our first RFI of 18 February 2011, we requested Anglian Water to provide a breakdown of cost information showing the costs of the assets used to serve the Priors Hall site. In its response, Anglian Water stated that it does not collect total cost information on a location-specific basis given that it applies uniform tariffs across its region. Although we sought local cost information again in our third RFI of March 2013, Anglian Water in its response was again unable to provide this information and referred back to its earlier reasoning. Based on the information we did receive from Anglian Water, we consider that the customer-specific costs at the site are de minimis in scale relative to the total costs of supplying the Priors Hall site.
- 4.28 We have therefore concluded that since most of the cost to Anglian Water of supplying potable water and sewerage discharge services to IWN fall into the common cost category, and cannot be attributed solely to IWN serving this site, we do not consider it is appropriate to deviate from AAC (and therefore the LUT) to assess costs because of geographical differences.

Test 2: Competition concerns

- 4.29 We consider that even though our assessment of the geographic nature of supply indicated that there is no reason to deviate from the LUT for the Priors Hall site, we may choose to do so if we have reason to think that using the LUT would raise material competition concerns. This is because in exercising our functions under both sections 40A and 110A of the Act, we must have regard to the desirability of:
- i. facilitating effective competition within the water and sewerage industries; and
 - ii. the existing undertaker (in the case of sewerage) or the supplier (in the case of water) recovering the expenses of complying with their obligations by virtue of sections 40A and 110A of the Act and securing a reasonable return on their capital.
- 4.30 In addition, IWN has argued that the bulk supply price set should allow the downstream entrant to recover the costs of its activities and that Ofwat therefore should be alert to the possibility of ‘margin squeeze’. This test addresses IWN’s concerns as well.

- 4.31 New entrants compete with incumbents to supply new developments. This is an emerging and fragile area of competition. A concern in this case is that the determined bulk supply price should not impede the ability of an equally efficient downstream provider to enter the market. This will be the case if the margin is insufficient to recover reasonable downstream costs – that is, resulting in a margin squeeze.
- 4.32 To mitigate the risk of setting a BSP that in effect results in a margin squeeze, we checked that the LUT for the bulk supply of both water and sewerage services is at a level which retains a sufficient margin for an equally efficient operator. By using Anglian Water’s own bulk pricing model to deliver a margin sufficient for an equally efficient operator (**EEO**), we estimate a price (for water and sewerage) which would enable efficient competition.
- 4.33 If the LUT is less than the price indicated by the bulk pricing model, we consider that the new entrant will retain a sufficient margin to remain in the market. If the LUT exceeds the price from the bulk pricing model, the margin the new entrant earns may be insufficient, indicating a potential margin squeeze.
- 4.34 To implement this test we used the retail-minus bulk pricing model supplied to us by Anglian Water in response to our first RFI of 18 February 2011. We undertook a sensitivity analysis of all the inputs (except for cost of capital) used by Anglian Water to calculate its retail-minus bulk supply price. Anglian Water used its actual weighted average cost of capital (**WACC**) as the relevant discount rate in its retail minus model submitted to us. However, this cost of capital is not relevant for two reasons.
- 4.35 First, Anglian Water’s cost of capital reflects various regulatory protections that have been put in place to benefit consumers and we consider the effect of these protections should be excluded in any analysis that compares an existing undertaker with a new entrant. Regulatory protections such as the revenue correction mechanism (**RCM**) and regulatory capital value (**RCV**) reduce the risk that Anglian Water faces in providing water and sewerage services to end customers. They were put in place to protect the interests of consumers, rather than to protect incumbents from competition. Therefore, we consider that the appropriate competition test should compare the margin available to an EEO excluding the cost impact of a lower cost of capital due to regulatory protections.

- 4.36 Second, as a general principle all project appraisals should be conducted using a project-specific cost of capital which captures the systematic risk of the project. Anglian Water's own group-wide regulated cost of capital applies to the whole of Anglian Water's business and therefore it reflects risks of the whole company, not the risks of a (notionally) independent downstream provider providing NAV services.
- 4.37 The relevant cost of capital is that which would apply to a notionally separated downstream provider of new appointee-like services. That would capture the project-specific risks, thereby better reflecting the risks involved in the business considered in the retail-minus model.
- 4.38 Based on work done for us by PwC on the cost of capital, we estimate that the equivalent cost of capital based on the WACC from the 2009 price review (PR09) would be between 6.6% and 7.8%.
- 4.39 PwC estimated the cost of capital that would apply to a notionally separated downstream provider of services, excluding regulatory protections designed to protect wholesale revenues, rather than downstream revenues. That analysis was wide ranging, and looked at different approaches to assessing the cost of capital, including benchmarking across regulators, comparisons across industries, direct estimation as well as incremental risk analysis which used business models to combine risk measures from different industries each of which represented a different risk faced by a downstream provider. Further details of PwC's analysis are included in appendix 2.
- 4.40 For the purpose of the competition assessment, we used Anglian Water's published LUT (industrial⁴) for 2012-13 to compare this to the bulk supply price calculated using Anglian Water's retail-minus model with a cost of capital of 7.2% (which is the central estimate in our range of 6.6% to 7.8%). Since the LUT (for water) is a multi-part tariff, comprising a fixed element, a volumetric charge and a peak load charge, and Anglian Water's bulk pricing retail-minus

⁴ Under this LUT the charge for potable water comprises: fixed charge – £3,440, volumetric charge – 27.30p/m³ and a maximum daily demand (MDD) charge – £168.01. The charge for wastewater comprises: fixed charge – £5,135 and volumetric charge – 124.96p/m³.

model provides a volumetric charge the two have been made comparable by converting to expected annual revenues based on anticipated demand once Priors Hall is completed. Table 1 below presents the results of the competition test.

- 4.41 Total demand on site, including total peak day flow have been estimated using the figures in Anglian Water’s retail-minus model on total bulk water supplied. These have been adjusted to include Anglian Water’s assumed on-site leakage estimates as a proportion of the total demand rather than being added to the total demand. We have therefore used an estimated demand figure of 748 megalitres (MI) a year and a total peak day flow of 3,018.1 MI in order to calculate anticipated revenues under the LUT and retail-minus approaches. As Anglian Water’s model was designed to generate a per m³ price for 2010-11, we inflated the price generated by the model to produce a price for 2012-13 using the Retail Prices Index (RPI).

Table 1 Anticipated annual revenues at the Priors Hall site at 2012-13 prices based on estimated demand of 748 MI per year (on site completion)

Bulk supply price	Water	Sewerage
LUT (industry)	£714,745	£939,836
Retail minus model	£754,334	£961,903

Source: Ofwat’s own calculation and Anglian Water’s charging scheme 2012-13.

- 4.42 Table 1 above shows that no margin squeeze occurs under our base assumptions since the LUT for water and sewerage remain below the price predicted by the retail-minus approach indicating that the LUT offers a sufficient margin for entry. We have subjected this test to a range of sensitivity analysis and broadly the results remain the same. One key exception is when substituting the cost of capital using the upper end of the estimated range (7.8%). In this case, the modelling suggests a minimal negative margin on the provision of sewerage services. However, we do not consider this to be sufficient to raise a competition concern because the actual cost of capital on a forward looking basis will be below that estimated in the range used.

4.43 Table 2 below shows the average equivalent prices in £ per m³ for the anticipated annual average revenue figures for 2012-13.

Table 2 Average equivalent prices 2012-13, per m³

Bulk supply price	Water	Sewerage
LUT (industry)	£0.96	£1.26
Retail minus Model	£1.01	£1.29

Source: Ofwat's own calculation and Anglian Water's charging scheme 2012-13.

4.44 Our assessment above shows that the LUT does not result in a margin squeeze. We have therefore concluded that there is no reason for deviating from the LUT due to competition reasons.

Test 3: Efficiency concerns

4.45 One of the arguments raised by Anglian Water (as mentioned in paragraph 4.5 above) to illustrate why the LUT is not an appropriate tariff for the Priors Hall site is because it considers new entrants that predominantly supply households have higher peak demand compared to a typical large user. In this context, Anglian Water considers that it is important to set a bulk supply price which incentivises all parties involved to manage the peak demand efficiently.

4.46 Anglian Water contends that a new appointee places a higher peak load on its water and sewerage networks than a typical large user and that therefore a new appointee should face a higher charge. We do not agree with Anglian Water for the following reasons.

- a. There is no evidence that Anglian Water incurs greater costs because of a higher peak load of a new appointee relative to large users. Rather, Anglian Water submitted information (which appears to be self-fulfilling) in the form of its cost allocation models to demonstrate that if costs were allocated on the basis of peak load factors, then, under its assumptions, new appointees would be allocated greater costs than large users.

- b. Anglian Water has not proposed an alternative price structure. It is unclear how simply separating out peak demand related costs and charging IWN a higher volumetric BSP would incentivise IWN to manage its demand differently and therefore promote efficiency.
- c. If IWN were to be incentivised to manage demand and reduce peak load, it could do so by installing a local reservoir after the meter to store water at low demand periods and provide water in peak periods thereby smoothing out the demand on Anglian Water's network. However, we consider Anglian Water may be better placed to determine where a local storage facility needs to be built. Indeed, Anglian Water already installs local storage throughout its network for the purpose of smoothing out peak demand requirements. There is also an advantage for this local storage to be part of Anglian Water's assets as it could be used by Anglian Water to also service other customers.
- d. The LUT for potable water already incorporates a peak load factor. Anglian Water has not demonstrated in its response to our request for information why this is not relevant for new appointees (including IWN for Priors Hall). Put differently, if peak load was expected to lead to higher costs we would expect Anglian Water to set the peak load charge as part of its LUT so as to reflect those costs and align any large user's incentives (including new appointees) with that of Anglian Water's. It is unclear to us from Anglian Water's submissions why a large user and a new appointee with the same peak demand would impose a different cost on Anglian Water and as a consequence warrant different treatment.
- e. Furthermore, in our consultation with key stakeholders (see paragraphs 4.53 to 4.55 and appendix 3 below), we sought to understand if peak demand is a material factor in the difference between supplying a new appointee (serving household customers) compared with a large user. Fewer than half of the respondents suggested that the demand profile is materially different for a new appointee serving households compared with a large user. Moreover, only one company stated that different demand profile translates into different costs, but it did not support that statement with evidence.

4.47 Therefore, we consider that there is no reason to deviate from the LUT because of efficiency concerns.

Minimise any potential inconsistencies with our potential future approach to charging

4.48 We stated in the framework that our current approach to assessing costs could lead to potential inconsistencies with the approaches to charging that we may adopt in future.

4.49 The framework states that depending on the nature of the determination, one option to avoid such a scenario is to include a ‘trigger’ mechanism in the supply or discharge agreement that would allow the parties to renegotiate the price if, for example, we materially changed our policy following the date of the determination. If no agreement is reached, then either party could refer the matter to us.

4.50 This option already exists in the form of a ‘statutory’ re-opener provision under sections 40A and 110A of the Act. These provisions allow the Parties to refer an existing agreement or prior determination to us for variation.

4.51 So, in effect, for the Priors Hall site bulk supply and discharge agreements, the Parties can re-negotiate the BSP (and other terms and conditions) if either are adversely affected in future, and if they fail to agree revised terms they can come to us to seek a variation to their existing agreements. We consider that the Parties themselves will be best placed to identify the impact of any future changes to the BSP set in this case.

4.52 Therefore, we do not propose to make any changes to the agreement between the Parties to address this issue.

(D) Summary of relevant stakeholder views on differences between large users and new appointees

4.53 In this section, we summarise our conclusions from the responses we received from selected companies on the factors that affect the provision of services to a new appointee serving household customers as compared with a large user.

- 4.54 As noted in chapter 3, we issued a RFI to all incumbent companies with new appointees in their areas of appointment (nine companies) and all new appointees themselves – apart from IWN (four companies) to inform our analysis in this case.
- 4.55 The two factors cited by a number of respondents as potentially affecting price, included demand levels and customer service costs. However, in both cases we did not consider that there was sufficient support for either factor, or sufficient evidence provided. Further details on the information we received from selected stakeholders is set out in appendix 3.

(E) Determination of bulk supply price

- 4.56 We received an application from Anglian Water on 17 December 2008 requesting us to vary the price terms of the bulk supply of potable water and the bulk discharge of wastewater provided by Anglian Water to IWN in relation to the Priors Hall site in Corby Northamptonshire, under sections 40A and 110A of the Act. As part of its application, Anglian Water said it considered the LUT to be inappropriate for the purposes of setting the BSP to be used in agreements with potential new appointees.
- 4.57 In order to assess the BSP for the Priors Hall site, we have:
- a. collected information from both parties in this case;
 - b. applied the published framework for resolving pricing disputes; and
 - c. collected information from selected stakeholders to inform our analysis.

This analysis is set out in detail in sections parts C and D above. In summary, the tests we have applied as set out in the framework (geographic, competition and efficiency), in conjunction with the information we have collected have demonstrated that there is no compelling evidence for us to deviate from the LUT as the BSP for the Priors Hall site. So, we do not agree with Anglian Water's view that an approach to bulk pricing based on retail minus is the most appropriate.

- 4.58 Therefore, we conclude that the LUT, at any given point in time, is the appropriate BSP to be used in the bulk supply and bulk discharge agreements between the Parties for the Priors Hall site.
- 4.59 As we are not varying the price terms within the bulk supply agreements, payment of compensation is not required by any party.

Appendix 1: Chronology of information requests

First information request

We issued a request for information (**RFI**) to the Parties on 18 February 2011 seeking information to inform our determination. In our RFI to Anglian Water we requested information on:

- a. the latest agreements between the Parties, including the details of any differences between new and old agreements;
- b. the services to be provided by Anglian Water to IWN under the terms of the agreements;
- c. details of the assets used to provide the relevant services to IWN;
- d. the costs associated with providing the relevant services to IWN;
- e. the difference between the Priors Hall site and other new appointment sites and/or large users in Anglian Water's supply area (in terms of the services provided, the assets used to provide those services and geographical/topographical differences); and
- f. Anglian Water's views on what it considered to be the appropriate prices for bulk water and sewerage services in this case.

In our RFI to IWN we requested information on:

- a. the latest agreements between the Parties, including the details of any differences between new and old agreements;
- b. the services to be provided by Anglian Water to IWN under the terms of the agreements between the Parties; and
- c. IWN's views on what it considered to be the appropriate prices for bulk water and sewerage services in this case.

Anglian Water provided a partial response to our RFI on 18 March 2011. This included responses to most of the questions we had asked in our RFI (as listed above). However, it did not include information on:

- a. the extent to which assets were being used to serve Priors Hall when compared with other customers;
- b. a breakdown of the costs of providing the relevant services to IWN at the Priors Hall site; and

- c. details of Anglian Water's views on the difference between the Priors Hall site and other new appointments sites and/or large users.

We also met with representatives from Anglian Water on 18 March 2011 to discuss some of the questions in our RFI and Anglian Water's ability to respond to these in the manner requested. In its letter dated 1 April 2011, Anglian Water stated the reasons why this information was not available – namely, that the information does not exist as its management accounting systems are not designed to produce the information sought in these questions.

We received further information following our meeting with Anglian Water on 1 April 2011. This included Anglian Water's views on why the published LUT was not the appropriate basis for a bulk supply price to a new appointee seeking a supply primarily for domestic use. It also provided additional information to support its view that the costs of supplying the Priors Hall site were not typical of its region as a whole.

IWN provided a response to the questions in our RFI on 1st April 2011

Second information request

We issued a second RFI to the parties on 24 July 2012. In our RFI to Anglian Water, we requested information on its LUT, including how this was constructed. In addition, we requested further information on its bulk supply pricing models for water and sewerage (provided to us in response to our RFI in 2011). In our RFI to IWN, we sought clarifications and further details from the company in relation to its response to our information request in 2011.

Anglian Water responded to our RFI on 17 August 2012. As part of this it provided its cost allocation models (for water and sewerage) which it had used to inform its previous response to us of 1 April 2011 (that is, Anglian Water's views on why it did not consider the LUT to be an appropriate price for bulk services to a new appointee). The cost allocation models consisted of two Microsoft Excel spreadsheets; one for water services and another for sewerage services.

IWN provided a response to our RFI on 7 September 2012. This included information on:

- a. assumptions regarding the build profile of properties on the site;
- b. the amount of water expected to be delivered per annum by Anglian Water at the point of connection;
- c. the amount of water IWN expected to be lost through onsite leakage per annum;
- d. the collection of infrastructure charges;
- e. the management of surface water drainage services on site; and
- f. the type of customer services required from Anglian Water, including the frequency of those services and the likely cost of procuring those services.

Third information request

We issued a third RFI to Anglian Water in draft on 19 February 2013. Given the information we were seeking, we considered that issuing a draft first would help us to clarify the purpose of our questions and Anglian Water's ability to respond to these in the form and manner requested, before we issued a final RFI to the company. We met with representatives from Anglian Water on 22 and 27 February to discuss our draft RFI questions and to discuss Anglian Water's cost allocation models in more detail. Following the meetings, we issued a third RFI to Anglian Water on 1 March 2013.

In this RFI to Anglian Water we included a number of questions which were split into the following categories.

- a. Questions on Anglian Water's bulk supply pricing model (water).
- b. Questions on Anglian Water's bulk pricing model (sewerage).
- c. Questions on Anglian Water's cost allocation model (water services).
- d. Questions on Anglian Water's cost allocation model (sewerage services).
- e. Questions on zonal and local costs.

We issued our third RFI to IWN on 6 February 2013. In this we asked IWN for information on the following areas.

- a. Volume assumptions in relation to the services being provided by Anglian Water.
- b. Evidence relating to customer operating expenditure and other downstream costs as a result of supplying the Priors Hall (and other housing development) site(s).
- c. Bad debt.
- d. Capital costs (including maintenance costs for on-site assets and the cost of capital for supplying the site).
- e. The actual tariffs paid by IWN to Anglian Water for the years to date.

Anglian Water provided a response to the questions in categories 'a' to 'd' of our third RFI on 28 March 2013. It followed this up with a response to the remaining questions in our RFI on 3 April 2013.

IWN provided a response to our third RFI on 28 February 2013.

Fourth and final information request

We issued a fourth and final RFI to Anglian Water only, on 17 June 2013. The purpose of this was to clarify Anglian Water's understanding of our previous questions (where Anglian Water had indicated that it had not understood them) in order to get an updated response from the company. In addition, we requested clarification on some of Anglian Water's previous responses (even where it had understood our questions). Finally, we asked for further information where we did not consider a satisfactory answer had previously been given. As part of this RFI, we said we were disappointed that, despite repeatedly requesting Anglian Water to explain how it had set its LUT, it had not provided us with a satisfactory answer in writing or in oral discussions. We asked the company to provide us with the methodology it uses to translate the outcomes from its cost allocation models into end tariffs.

Anglian Water responded to our fourth RFI on 12 July 2013. As part of this it set out a summary overview of the process by which it sets tariffs, including the LUT. However, it noted that that it was not possible to use the outcomes of its cost allocation models using actual costs to set the level of actual tariffs.

Information request to relevant stakeholders

Alongside the RFIs we sent to the Parties in July 2012 (that is, our second information request), we also issued a request for information to relevant stakeholders to inform our analysis in this case. Specifically, we wrote to all incumbent companies with new appointees in their areas of appointment (nine companies) and all new appointees themselves – apart from IWN (four companies).

In our RFI to these stakeholders we sought information so that we could better understand the costs associated with the provision of a bulk supply of water and bulk discharge services to a new appointee serving a development consisting primarily of residential properties. In particular, we requested a response to the following questions (for both water and wastewater services).

- a. What factors affect the cost of serving a housing development (through a bulk supply to a new appointee) versus a large user of similar annual consumption/discharge? (In the text supporting this question we had listed possible reasons why the cost of serving a new appointee might be different from the cost of serving a large user⁵ – referring to those factors, we also asked whether they gave rise to any differences in cost or whether there were other factors to be considered.)
- b. For each factor you have identified, please explain why it affects the cost of serving the two different customers and assess the materiality of each factor. Where possible, please quantify any differences. Where you are not able to quantify, please explain why you are unable to do so.

⁵ These were the same factors cited by Anglian Water in its letter to us dated 1 April 2011 and which are described in paragraph 4.5 of this document.

- c. Please explain the overall effect of the different factors on the price of a bulk service to a large user versus a new appointee.

We received responses from all stakeholders that we had written to between July and September 2012. A summary of the responses we received are set out in appendix 3.

Appendix 2: Cost of capital analysis for competition test

As part of the competition test which we applied in this case we used work done for us by PwC on the cost of capital.

PwC began with the cost of capital inputs used for PR09. It then estimated that – ignoring incumbency advantages – the notional downstream provider would face materially different risk to a vertically integrated company. This is reflected in a larger asset beta. Because of this extra risk, equity holders would choose a different gearing ratio and also debt holders would demand a higher return and PwC adjusted those inputs accordingly.

A notional downstream provider would also have to bid for most of its work, which is not the case for an appointed monopoly which faces little, if any, competition for its customers. PwC used estimates of bid costs from Private Finance Initiatives (PFIs), which indicated an uplift in the WACC. PwC considered that bid costs would not be as large for a new appointee as for PFIs and reduced the bid cost uplift.

In addition, PwC removed the incumbency advantages inherent in the cost of capital of an appointed monopoly by applying uplifts for removing the regulatory protections (as set out in paragraph 4.35 of the determination). It also applied uplifts for removing contractual risk. This refers to the incumbency advantage from being vertically integrated which means the incumbent, unlike a separate EEO, would not face the risk of a failure to reach agreement on future bulk supply agreements.

The range of 6.6% to 7.8% (pre-tax) from PwC's analysis is based on historic data and arguably for a price determination it would be more appropriate to take a forward-looking approach to assessing the relevant cost of capital. However, for the purpose of the competition assessment we use the historic value in the first instance because we consider that a forward-looking cost of capital could only be lower. A lower cost of capital would lead to lower costs for the notional downstream provider, a lower margin requirement for a new entrant and therefore a higher retail-minus based BSP. As such, if the existing BSP (that is, the LUT) is already lower than the retail-minus BSP with the higher historic cost of capital, it must be lower than a retail-minus BSP using a lower, forward-looking cost of capital.

Appendix 3: Summary of responses to our general RFI to relevant stakeholders in July 2012

On 24 July 2012, we issued an RFI to all incumbent companies with new appointees in their areas of appointment (nine companies) and all new appointees themselves – apart from IWN (four companies) to inform our analysis in this case.

In the RFI to companies we asked the following questions.

1. What factors affect the cost of serving a housing development (through a bulk supply to a new appointee) versus a large user of similar annual consumption/discharge? For example, do the factors described give rise to any differences in cost or are there other factors that should be considered? As background to the set of questions we listed the four factors cited by Anglian Water (without naming the company) as reasons why supplying a large user might be considered different from supplying a new entrant.
2. For each factor identified, we asked the companies to explain why that factor affects the cost of serving the two different customers and asked them to assess the materiality of each factor. Where possible, we asked them to quantify any differences and if they were unable to do so, to explain why they were unable to do so.
3. We asked companies to explain the overall effect of the different factors on the price of a bulk service to a large user as opposed to a new appointee.

The two factors which were cited by the respondents as potentially affecting price were demand levels and customer service costs. We have considered these two factors further as explained below.

Peak demand of NAVs relative to large users

Five incumbent companies held the view that the demand profile of a large user is generally 'less peaky' than household customers supplied by a new entrant. In translating this to cost, one company did not consider the difference in costs was materially significant, while another company submitted that this difference would be reflected in infrastructure reinforcement costs. Therefore, on the whole we did not receive evidence which quantified the assertions made.

Other points expressed by existing incumbents with new appointees in their areas on this issue included the following.

- a. A new appointee serving households is likely to have a greater peak to average demand ratio than a large user – for sewerage, peak and off peak costs are less clear.
- b. The consumption of large users is generally less peaky than household customers; however, there are differences between customers within each class.
- c. When comparing the total large user demand profile through the year with that of measured small commercial and domestic customers, one existing appointee did not see significant differences in volatility.
- d. The demand profile for household developments may be more peaky than for large users, even if the same volume of water is used.
- e. Broadly, compared with an average commercial customer with average peak characteristics, for a new housing development the costs of providing supply network infrastructure would be 45% higher and the resources and treatment capital costs would be 25% higher.
- f. For a typical new appointee (without its own on site storage) the demand profile is comparable with that of a domestic premise and thus no costs are avoided. This undermines the case for using LUT band tariffs.

Based on our analysis presented under the efficiency test of the framework, we have concluded that including peak demand costs in the BSP is unlikely to incentivise different parties to manage these demands and accordingly should not be a factor in setting the final BSP in this case.

Customer service costs

Although 9 out of 13 respondents said that customer service costs could be a possible factor affecting the cost of serving a new entrant serving a housing development versus a large user (resulting in higher costs to serve a new entrant), all existing incumbents were of the view that these costs would not be material. Two new entrants expressed the view that the charge for retail services should be lower for supplying a new entrant as opposed to a large user.

Other points expressed by incumbents on this issue included the following.

- a. One company did not consider there to be a material difference in customer service costs for a large user and a 'mature' new appointee.
- b. Another company thought this is the only area where there might be a differentiation between large users and new appointees – overall, it considered that this should result in a small discount for bulk supplies – around 1% to 3% depending on the value of the supply.
- c. One respondent said it does not expect any material differences in customer service costs between a new appointee and a large user.
- d. Based on its own experience, one company said that bulk supply customers have not required different levels of service from those already available to large users.
- e. Another company stated a new appointee may require a different level of customer service than a large user and where certain services are not provided, a discount is offered.

- f. Another respondent thought that management time is almost certainly greater for new appointees than for large customers. However, it added that there are also areas of customer service where the costs would be lower – for example, costs around the GSS. It noted that differences in costs for customer service are low in terms of their materiality and said that usually the full costs of dealing with the new appointee will be proportionate to that of dealing with a large user customer.

The majority of the respondents were of the opinion that these are not material enough to impact the price charged to either a large user or a new entrant supplying a household. We agree with this view in relation to Priors Hall based on our analysis of the cost information we have received from Anglian Water with regard to Priors Hall.

Credit risk of new appointees

Seven incumbent companies did not support the view that credit risk associated with serving a new entrant and a large user is different enough to result in a difference in cost of supply. While one incumbent and one new entrant noted that credit risk for a new entrant may be greater it added that this may be mitigated to some extent by the financial fitness test performed by Ofwat prior to granting a new appointment or variation.

Water quality

Nine out of thirteen respondents (including one new entrant) did not support the view that quality of water is a reason justifying a difference in cost of supply. One company noted that this factor would only be reflected in the price to a large user or a new entrant if it was possible to supply the specified quality. Another company agreed that while this could be a reason for a difference in cost of supply, in practice any cost reduction would depend on the site proximity to a water source and any raw water network.

Appendix 4: List of documents relevant to this determination

IN 13/08, 'Ensuring consistency in our approach to resolving pricing disputes' (August 2013)

http://www.ofwat.gov.uk/regulating/casework/prs_in1308bulksupply.pdf

Bulk supply pricing – a statement of our policy principles (February 2011)

http://www.ofwat.gov.uk/competition/inset/pap_pos110228navbulksupply.pdf

New appointments and variations – a statement of our policy (February 2011)

http://www.ofwat.gov.uk/competition/inset/pap_pos110228navpolicy.pdf

Anglian Water Limited charges schemes for 2012-13

<http://www.anglianwater.co.uk/business/your-account/tariffs/our-charges-scheme.aspx>