

To: Regulatory Directors
By email

18 August 2014

Dear Regulatory Director

The costs principle and access pricing – companies operating wholly or mainly in Wales

The legal framework for the WSL market was put in place by the Water Act 2003. Part of that framework covers the charges that should be paid by licensees to water undertakers for a supply of water to serve their customers.

Section 66D(3) of the Water Industry Act 1991 (as amended by the above Act) requires the charges payable by a licensed water supplier to a water undertaker to be fixed in accordance with the 'costs principle'.

Essentially, the costs principle allows the undertaker to recover from the supplier relevant expenses reasonably incurred, and the appropriate amount in respect of qualifying expenses and a reasonable return, to the extent that those sums exceed any financial benefits which the undertaker receives as a result of the supplier supplying water to the premises of relevant customers.

Previously the most appropriate approach under the costs principle was a 'retail-minus' approach, whereby to calculate an access price undertakers started with the retail price to customers, subtracted any retail costs that were adjudged avoidable, reducible or recoverable in some other way ('ARROW' costs) and then added back on any expenses of dealing with the licensee, as opposed to the customer. In particular, this was an appropriate approach for assessing these elements in the absence of more disaggregated costing information.

The Water Act 2014 (which received Royal Assent on 14 May 2014) includes provisions that will eventually remove the costs principle from legislation - the application of which has been widely cited as creating an inefficient barrier to competition - and replace it with a new charging regime based on Ofwat charging rules developed in the light of Government charging guidance.

Although the non-household retail market will not be changing in the company areas operating wholly or mainly in Wales, following the Water Act, the charging rule framework will still apply.

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'methodology'), which we published in July 2013, we stated we would set up to four separate price controls for each company. These are in the following areas.

- Household retail services.
- Non-household retail services.
- Wholesale water services.
- Wholesale wastewater services.

Consequently, from February 2015, when new charges are published (and potentially before through our draft and final determinations) there will be transparent wholesale charges for the first time. We consider that these will be a more appropriate basis for access pricing.

In any determinations relating to non-household retail access to wholesale services that are referred to us from now on (under section 66D), we intend (subject to any objectively justifiable reasons to the contrary) to set access prices in line with a bottom-up wholesale charging approach - as opposed to retail-minus. We consider this to be the most beneficial approach for customers.

This approach reflects the improved quantity and quality of information on retail access pricing that is now available to us through companies' default tariffs and the separate price caps under the current price control.

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Because such enhanced information is not available in relation to activities taking place under the current supplementary authorisation in the combined WSL licence, this approach is focused on the pricing of retail access to wholesale services only.

We expect water companies to consider moving away from a retail-minus approach when approached by WSLs for bundled access prices.

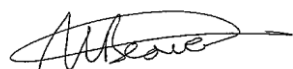
The Water Act 2014 will enable us to prepare charging rules, and we will consult on these in due course. In the meantime, we consider that basing access prices on wholesale charges is the more appropriate approach in the interests of customers. We expect companies to use their draft wholesale charges (charges based on their

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draft determinations) as the starting point for setting access prices prior to the final determinations, and for these to be reflected in their access codes, which are due to be published on 15 October.

Yours sincerely

A handwritten signature in black ink, appearing to read 'A. Beaver', with a long horizontal flourish extending to the right.

Andrew Beaver
Director of Strategy